Petition

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IN THE

Supreme Court of the United States

October Term, 1981

RALPH E. HUDDLESTON and
CHESTER E. BRADLEY, Jr.,
individually and as designated Class Representatives *et al.*,
Petitioners,

v.

HERMAN & MACLEAN, LAWRENCE A. LOPATIN,
and LESLIE SHARE,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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December, 1981

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QUESTIONS PRESENTED FOR REVIEW

1. Is the clear and convincing standard the appropriate burden of proof in private Rule 10b-5 actions?

2. Must individual reliance be proved in private Rule 10b-5 actions involving half-truths or a fraud on the market?

3. Does the plaintiff bear the burden of proving his own due care in a private Rule 10b-5 case?

4. Should defendants found liable for fraudulent misrepresentations and other intentional violations of Rule 10b-5 be able to seek contribution from a settling defendant?

5. Can a federal appellate court construe a state securities statute contrary to the interpretation of that state's highest court?

PARTIES

Petitioners – appellees in the Court below – are Ralph E. Huddleston, Chester E. Bradley, individually and as class representatives, the class they represent, and David E. Kemp, Thomas F. Plant, Felton E. Waggoner, Jack H. Barrett, and Daryl Lostax. Respondents – appellants in the Court below – are Herman & MacLean, certified public accountants, Lawrence A. Lopatin, and Leslie Share.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners, Ralph E. Huddleston and Chester E. Bradley, Jr., individually and as designated class representatives, and individual Petitioners David E. Kemp, Thomas F. Plant, Felton E. Waggoner, Jack H. Barrett, and Daryl Lostax, respectfully petition this Court, pursuant to 28 U.S.C. § 1254(1) and Rule 19 of the Rules of this Court, for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit, in the case of *Huddleston v. Herman & MacLean,* 640 F.2d 534.

OPINION BELOW

The opinion of the Court of Appeals is reported at 640 F.2d 534 and is set forth in the Appendix to the petition for a writ of certiorari filed by Herman & MacLean, No. 81-680. App. A-1, No. 81-680.[1] The opinion of the Court of Appeals denying Petitioners' petition for rehearing and for rehearing *en banc* is unreported and is set forth in the Appendix in No. 81-680. App. B-1, No. 81-680. The District Court issued no opinion. It did render a final judgment dated October 16, 1979 containing factual and legal findings based on a special verdict. App. C-1, No. 81-680. The answers given by the jury to special issues pursuant to Rule 49(a) of the Federal Rules of Civil Procedure appear in the Appendix filed herewith. App. A.

JURISDICTION

The judgment of the Court of Appeals was entered on March 9, 1981. A timely petition for rehearing and for rehearing *en banc* was denied on July 13, 1981. App. B-1, No. 81-680. On Petitioners' timely motion filed September 25, 1981, this Court extended the time within which to file a petition for writ of certiorari until December 10, 1981. *Huddleston v. Herman & MacLean,* A-259, order dated September 28, 1981. This Court has jurisdiction to review the decision of the Court of Appeals for the Fifth Circuit under 28 U.S.C. § 1254(1).

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[1]References to the Appendix to the petition in No. 81-680, Herman & MacLean v. Ralph E. Huddleston and Chester E. Bradley are identified as "App.____, No. 81-680." References to the Appendix filed with this petition are identified as "App.____."

STATUTES AND REGULATIONS INVOLVED

The following statutes and regulations are pertinent to this case: section 10(b) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78j(b), Rule 10b-5, promulgated by the Securities and Exchange Commission thereunder, 17 C.F.R. § 240.10b-5, and section 33 of the Texas Securities Act, Art. 581-33(A)(2), Tex. Rev. Civ. Stat. (Supp. 1963). The relevant texts of the foregoing are set forth in the Appendix filed herewith. App. B.

STATEMENT OF THE CASE

In 1969 Texas International Speedway, Inc. ("TIS"), a Texas corporation, filed a registration statement and prospectus with the SEC and the Texas State Securities Board in connection with the proposed sale to the public of $4,398,900 in securities, the proceeds of which were to be used to pay for the construction of an automobile speedway. The entire issue was sold to the public through an underwriting syndicate on October 30, 1969. However, the corporation filed a petition for Chapter X bankruptcy 13 months later, on November 30, 1970.

Petitioners Huddleston and Bradley, on behalf of themselves and other purchasers of TIS securities, filed a class action suit in 1972, seeking damages from Respondent Lopatin, the former President, Treasurer, and Director of TIS; from Respondent Share, the former Executive Vice-President and Director of TIS; from Respondent Herman & MacLean, the former certified public accountants for TIS; and from others who are no longer parties to this action.[2] Although the complaint

[2]With court approval, Petitioners compromised their claims against the underwriters of the TIS securities and against the speedway contractor.

alleged violations of a number of federal and Texas laws, when the case was submitted to the jury in 1979 only claims under section 10(b) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78j(b), and section 33 of the Texas Securities Act, Art. 581-33(A)(2), Tex. Rev. Civ. Stat. (Supp. 1963), remained at issue.

Petitioners' essential claim was that Respondents agreed on a scheme and course of conduct to misrepresent intentionally and conceal material facts regarding the financial condition of TIS, which would have revealed TIS' insolvency after the public offering. App. C-3, No. 81-680.

The case was submitted to the jury on special issues in accordance with Rule 49(a) of the Federal Rules of Civil Procedure. The jury found, *inter alia,* 1) that Respondents were responsible for recklessly preparing a prospectus that was materially misleading as to the land, construction, and start up costs for the speedway track, and the projected working capital of TIS on October 30, 1969; 2) that Respondents Lopatin and Share engaged in acts, practices, and a course of conduct which operated as a fraud upon purchasers of TIS securities including a) causing the pro forma balance sheet to show a total of $389,641 cash available after the public offering when in fact there was a negative working capital, b) failing to disclose that prior to the public offering a large loan was obtained from a company affiliated with the principal contractor of the speedway, c) causing an engineering firm to allow the use of its name in the prospectus as an expert with respect to estimated construction costs in the use of proceeds section when it had not performed due diligence procedures to determine the accuracy of these estimates; 3) that Respondent Herman & MacLean aided and abetted this fraudulent and unlawful conduct; 4) that Respondents

Lopatin, Share, and Herman & MacLean were "sellers" under the Texas Securities Act. App. A.

Following the jury's finding of liability against Respondents, the trial court – finding Respondents violated Rule 10b-5 and the Texas Securities Act "by reason of material omissions and fraudulent non-disclosures in the TIS Registration Statement during the class period and thereafter by their failure to correct said omissions and non-disclosures or to give notice of the insolvency of TIS," App. C-3, No. 81-680 – determined damages, awarded attorney's fees, and entered judgment for Petitioners.

On appeal, the Court of Appeals for the Fifth Circuit reversed. Although the Court affirmed the existence of a private cause of action under section 10(b) and Rule 10b-5, it held that the trial court had erred in failing to submit special issues on reliance and causation to the jury. According to the Court the trial court "confused materiality with reliance" and improperly concluded that reliance and proximate causation are questions of law, rather than fact. App. A-23, No. 81-680.

The Fifth Circuit also held that the plaintiff in a Rule 10b-5 action bears the burden of proving that he exercised due diligence in purchasing the security. App. A-22, No. 81-680.

Reviewing *sua sponte* the question of the standard of proof, the court of appeals held that in a Rule 10b-5 action, the proper standard is clear and convincing evidence, rather than the traditional civil standard of preponderance of the evidence. App. A-16-18, No. 81-680.

On damages, the Fifth Circuit held that it was improper to apply a rescissionary measure of damages in a Rule

10b-5 action and that the trial court erred in denying Respondents the right to seek contribution against the underwriters and the principal contractor for the speedway who had settled with Petitioners prior to trial. App. A-39, 45, No. 81-680.

Turning to the Texas Securities Act, the Fifth Circuit ruled that the trial court had improperly charged the jury as to the meaning of "seller" under the Act and held that the trial court should have directed a verdict for Respondents on this claim. App. A-28-29, No. 81-680.

REASONS FOR GRANTING THE WRIT

I. The Proper Standard of Proof for Rule 10b-5 Actions Is an Important Question of Federal Securities Law on Which a Split of Authority Exists Among the Courts of Appeals and Which Should Be Resolved by this Court.

The Court below held that the "clear and convincing evidence" standard is required to prove each element of a Rule 10b-5 case. The Fifth Circuit standard conflicts with decisions of this Court and those of other courts that impose a preponderance of the evidence standard in civil cases brought under the antifraud provisions of the federal securities laws. In *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943), this Court applied the preponderance standard to cases brought under section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) – a provision that is similar to Rule 10b-5. *See, e.g., Aaron v. SEC*, 446 U.S. 680, 696 (1980) (comparing Rule 10b-5(b) to section 17(a)(2)). Similarly, other courts of appeals

have adopted the preponderance standard in Rule 10b-5 cases and other actions under the federal securities laws.[3]

The Fifth Circuit's opinion also disregards this Court's directive in *Addington v. Texas,* 441 U.S. 418, 423 (1979), that the determination of an appropriate standard of proof requires a balancing of interests in order "to allocate the risk of error between the litigants and to indicate the relative importance attached to the ultimate decision." 441 U.S. at 423. Thus, this Court in *Addington* required the clear and convincing standard before an individual could be confined indefinitely in a mental institution. *See also Woodby v. Immigration and Naturalization Service,* 385 U.S. 276, 286 (1966) (requiring clear and convincing evidence standard in deportation proceedings).

The possible opprobrium to a defendant that may result from an adverse private Rule 10b-5 decision clearly falls far short of the extraordinary interests that warrant the clear and convincing standard of proof. Indeed, in *Vance*

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[3]*See, e.g.,* Mihara v. Dean Witter & Co., 619 F.2d 814, 824-25 (9th Cir. 1980) (court approved preponderance standard in "churning" case brought under section 10(b) of the Securities Exchange Act and Rule 10b-5); *accord,* Dzenits v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168, 171 n.2 (10th Cir. 1974); G.A.F. Corp. v. Milstein, 453 F.2d 709, 718 (2d Cir. 1971), *cert. denied,* 406 U.S. 910 (1972) (plaintiff in an injunctive action under section 13(d) of the Securities Exchange Act of 1934 should be given opportunity to prove case by a "fair preponderance of the evidence"); Globus v. Law Research Services, 418 F.2d 1276, 1291 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970) (causation in Rule 10b-5 action was properly shown "by a fair preponderance of the evidence"); University Hill Foundation v. Goldman, Sachs & Co., 422 F.Supp. 879, 897 (S.D.N.Y. 1976) (plaintiffs did not prove their case under section 12(2) of the Securities Act of 1933, and section 10(b) of the Securities Exchange Act of 1934 "by a preponderance of the evidence"); *see also* DeVitt & Blackmar, Federal Jury Practice and Instructions §§ 98.04, 98.12, 98.13 (3d ed. 1977) (preponderance standard applies to jury's findings in Rule 10b-5 actions).

v. Terrazas, 444 U.S. 252, 266-67 (1980), this Court held that the preponderance standard, not the clear and convincing standard, applies to an expatriation proceeding. *A fortiori,* application of the preponderance standard is fair here. The interests of those such as Respondents who have participated intentionally in the fraudulent sale of securities to the public do not outweigh the interests of those who purchased the securities and lost their money, the very people whom the federal securities laws are intended to protect.[4]

In addition, the Fifth Circuit's opinion creates an anomaly when read in the light of this Court's decision last term in *Steadman v. SEC,* 101 S.Ct. 999 (1981), which held that the preponderance of the evidence standard applies in SEC administrative proceedings brought pursuant to section 9(b) of the Investment Company Act of 1940 and section 203(f) of the Investment Advisers Act of 1940, 15 U.S.C. §§ 80a-9(b), 80b-3(f). Since the Court based its holding on an interpretation of section 7(c) of the Administrative Procedure Act, 5 U.S.C. § 556(d), *Steadman* is technically distinguishable from the present case. Nevertheless, under the Fifth Circuit's ruling, the defendant in an SEC proceeding would be afforded only a preponderance standard, but in a private Rule 10b-5 case the same

[4]One reason offered by the Fifth Circuit to justify imposition of the clear and convincing standard is that "proof of intent to deceive is often a matter of inference . . . ." App. A-17-A-19 n.19, No. 81-680. This Court, however, has previously sanctioned use of the preponderance test in federal securities cases that rely on inferential or circumstantial evidence. SEC v. C.M. Joiner Leasing Corp., *supra,* 320 U.S. at 355. Courts in civil cases frequently rely on inferences to prove state of mind. *See, e.g.,* Vance v. Terrazas, *supra,* 444 U.S. at 267. In fact, this Court has recognized that "[c]ircumstantial evidence is not only sufficient, but may also be more certain, satisfying, and persuasive than direct evidence." Michalic v. Cleveland Tankers, Inc., 364 U.S. 325, 330 (1960).

defendant would be afforded the higher standard, even though the potential harm to a defendant from an erroneous decision in an SEC administrative proceeding where his business and livelihood are at risk is far greater than in a private Rule 10b-5 action, where at most he faces money damages and a prohibition against trading in a particular security.[5]

Lastly, in reaching its conclusion that the clear and convincing standard applies in Rule 10b-5 actions, the Fifth Circuit erroneously relied on civil fraud principles. The scope of the antifraud provisions of the federal securities laws is not coextensive with common law principles of fraud and deceit. *See generally Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 744-45 (1975). For example, a common law action for deceit was not traditionally available for nondisclosure or half-truths. *See* W. Prosser, *Handbook of the Law of Torts* § 106 at 695-696 (4th ed. 1971). Because common law principles of fraud should not govern intangibles such as investment advice and securities, the federal securities laws were enacted "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180, 186, 194 (1963) (footnote omitted).

Consistent with this approach, some state courts have adopted the preponderance standard in common law fraud

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[5]For example, the *Steadman* defendant, whose case was governed by the preponderance standard, "faced indefinite exclusion from the investment advisory business and the forced sale of all his interest in [his investment company]." Steadman v. SEC, 603 F.2d 1126, 1139 (5th Cir. 1979). By contrast, Respondents here face only actual money damages.

cases involving violations of securities or blue sky laws.[6] Even outside the area of securities fraud, a significant number of state courts, finding no sound reason why defendants charged with fraud should be accorded special evidentiary protection at the expense of those claiming injury, have adopted the lower standard of proof.[7] This case clearly presents an appropriate vehicle for this Court to enunciate a uniform standard of proof in Rule 10b-5 cases.

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[6] *See, e.g.*, S & F Supply Co. v. Hunter, 527 P.2d 219, 220-21 (Utah 1974) (preponderance of evidence required to prove fraud); *see also* 11C (Part 2) H. Sowards and N. Hirsch, Business Organizations Blue Sky Regulation § 6.01 at 6-4 to 6-5 (1979) (footnote omitted): "The nature of the blue sky laws virtually demands that they be liberally interpreted in order to effectuate the antifraud purposes. This . . . has altered the principle governing the weight of evidence in civil cases . . . . [F]raud actions brought under the blue sky laws have been decided in some states according to a fair preponderance of the evidence, which has been described as a probability of belief by triers of fact."

[7] *E.g.*, Ray Dodge, Inc. v. Moore, 251 Ark. 1036, 1041, 479 S.W.2d 518-522 (1972) (Arkansas); Liodas v. Sahadi, 562 P.2d 316, 321-323, 137 Cal. Rptr. 635, 639-643 (1977) (California); Goodfellow v. Kattnig, 533 P.2d 58, 60 (Colo. App. 1975) (Colorado); Rigot v. Bucci, 245 So.2d 51, 53 (1971) (Florida); Blaeser Development Corp. v. First Federal Savings & Loan Ass'n, 375 So. 2d 1118 (Fla. App. 1979) (Florida); Grissom v. Moran, 154 Ind. App. 419, 427, 290 N.E.2d 119, 123 (1972) (Indiana); Cowan v. Westland Realty Co., 162 Mont. 379, 383, 512 P.2d 714, 716 (1973) (Montana); Medivox Productions, Inc. v. Hoffman LaRoche, Inc., 107 N.J. Super. 47, 69, 256 A.2d 803, 814-815 (1969) (New Jersey); Smith v. Rhode Island Co., 39 R.I. 146, 153-154, 98 A. 1,4 (1916) (Rhode Island); General Electric Credit Corp. v. M.D. Aircraft Sales, Inc. 266 N.W.2d 548, 550 (S.D. 1978); Hamm v. Crockett, 576 S.W.2d 871, 872 (Tex. Ct. App. 1979) (Texas); In re Delligan's Estate, 111 Vt. 227, 234-235, 13 A.2d 282, 287 (1940) (Vermont). *See also* Jensen v. Sohler, 601 F.2d 353, 354-355 (8th Cir. 1979).

II. The Decision of the Court Below Requiring Proof of Individual Reliance in Rule 10b-5 Actions Involving Half-Truths and a Fraud on the Market Is in Conflict With the Decisions of the Courts of Appeals of Other Circuits and With Decisions of this Court.

The Court below held that Petitioners bear the burden of proving that they relied upon the material misrepresentations and half-truths contained in the TIS prospectus. App. A-21-25, No. 81-680. It thus ignored the holdings of this Court and rejected the decisions of the courts of appeals of other circuits that in cases involving "fraud on the market" or material half-truths individual proof of reliance is unnecessary.

Because private actions under Rule 10b-5 have been created judicially, it has fallen to the courts to determine the elements of Rule 10b-5 suits. Borrowing from the common law action of misrepresentation, the courts have held that in most private Rule 10b-5 cases the plaintiff must prove reliance, which establishes the causal link between defendant's misconduct and the harm suffered by plaintiff. *E.g., List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *see generally* W. Prosser, *Handbook of the Law of Torts* § 108 at 714-720 (4th Ed. 1971).

In two seminal decisions, however, *Mills v. Electric Auto-Lite*, 396 U.S. 375 (1970), and *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), this Court held that in certain circumstances proof of individual reliance is unnecessary; that the causal link between defendant's fraud and plaintiff's economic harm may be presumed.

A. The presumption of reliance should apply to cases involving a "fraud on the market."

Mills v. Electric Auto-Lite, supra, was a class suit brought by minority shareholders under section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), alleging that a proxy statement contained misleading statements. Recognizing that reliance by the thousands of individuals voting in accordance with the proxy statement could "scarcely be inquired into," 396 U.S. at 380 (quoting the court of appeals), the Court held that there is no need to prove that the "defect actually had a decisive effect on the voting." *Id.* at 385. Rather, "[w]here there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if . . . he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction." *Id.*

Most lower federal courts have interpreted *Mills* as an evidentiary ruling that creates a presumption of reliance whenever the defendant's fraudulent conduct affects the market in which the plaintiff purchased or sold his security. *E.g., Blackie v. Barrack,* 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976); *Herbst v. ITT,* 495 F.2d 1308 (2d Cir. 1974). Under such circumstances, the causal link between defendant's fraud and plaintiff's injury is established not by proof that the plaintiff relied on a particular misrepresentation, but by the fact that the misrepresentation resulted in the manipulation of the market in which plaintiff purchased or sold his securities.

Establishing a "presumption" of reliance in such cases is not unjustifiable speculation that someone somewhere "must have relied" on the misrepresentation. By definition

for facts to be material, they must be such that a "reasonable investor might have considered them important in the making of [the investment] decision." *Affiliated Ute, supra,* 406 U.S. at 154.[8] To presume from the fact that a reasonable investor "might have considered" misrepresentations "important" in making his investment decision that the misrepresentations were considered by brokers, underwriters, and investors generally and were reflected in the market price of the public offering and in the decision of the underwriter to market the security at any price is a compelling logical step. Indeed, the *Mills* Court adopted this reasoning in its analysis:

> Where the misstatement or omission in a proxy statement has been shown to be 'material' . . . that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. 396 U.S. at 384 (footnote omitted).

A presumption of reliance is justified logically on the ground that material misrepresentations and half-truths in a registration statement and prospectus are inevitably reflected in the decision of an underwriter to market a security and generally in the market price of publicly traded securities. It is also justified by the impracticalities of proving individual reliance whenever large numbers of investors have been defrauded. As the Court recognized in

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[8]The trial court in the case at bar used the higher standard of materiality set forth in TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976) (suit under section 14(a) of the Securities Exchange Act of 1934; fact is material if there is a "substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote").

Mills, determining whether the misleading statements contained in a proxy statement actually had a decisive effect on the voting would be a practical impossibility. 396 U.S. at 380, 385. In the case at bar, too, it is a practical impossibility to prove individual reliance on the part of each member of the class. The "objective test" adopted in *Mills* avoids these impracticalities and, "by resolving doubts in favor of those the statute is designed to protect, will effectuate" the congressional policy. *Id.* at 385.

Requiring individual proof of reliance by all purchasers of securities fraudulently marketed will effectively insulate the wrongdoers from all injured parties but the "unlikely few who actually viewed and relied on the misleading information." *Ross v. A.H. Robins Co., Inc.*, 607 F.2d 545, 556 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980). Moreover, requiring individual proof of reliance ignores the reality of most securities transactions. To be sure, some purchasers of securities will dutifully examine a prospectus to determine whether to invest in a new issue. But most purchasers will rely on recommendations made by brokers or underwriters whose own examination of and reliance upon the prospectus will be decisive in determining whether the security is sold and the price at which it is traded. *Cf. Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363 (1966).

For example, in the case at bar, had Respondents disclosed in the prospectus and registration statement the fact that TIS was insolvent even after receipt of the proceeds of offering[9] the underwriters would have withdrawn or substantially revised the offering. The material

[9] *See* final judgment of the District Court, App. C-3, No. 81-680 (Respondents violated Rule 10b-5, *inter alia*, by their failure to "give notice of the insolvency of TIS").

misrepresentations and scheme to defraud caused Petitioners' injury regardless of whether any of them relied upon or even saw the prospectus.

Despite this, the Court below rejected without discussion the presumption of reliance in the market fraud context. This decision conflicts with the decisions of the courts of appeals of at least four other circuits. *Wachovia Bank and Trust Co. v. National Student Marketing Corp.*, 650 F.2d 343, 357 (D.C. Cir. 1980) (under section 10(b) reliance is presumed "if the misstatement affects the price of the stock"), *cert denied*, 49 U.S.L.W. 3931 (June 15, 1981); *Ross v. A. H. Robins Co., Inc., supra*, 607 F.2d at 533 (under section 10(b) reliance is presumed if the material misrepresentation "affected the price of stock traded on the open market"); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 381 (2d Cir. 1974) (under section 10(b) proof of causation is unnecessary when scheme to defraud includes "market manipulation"), *cert. denied*, 421 U.S. 976 (1975); *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 374-375 (2d Cir.) (under section 14(e) presumption of reliance from fact that representations are material), *cert. denied*, 414 U.S. 910 (1973); *Sanders v. John Nuveen & Co., Inc.*, 619 F.2d 1222, 1227 (7th Cir. 1980) (under section 12(2) a "prospectus that reports on the issuer's financial condition affects [the market] price"), *cert. denied*, 101 S.Ct. 1719 (1981); *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1271 (9th Cir. 1979) (under section 10(b) reliance is presumed from the "natural process of the market"); *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975) (under section 10(b) "[m]ateriality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price"), *cert. denied*, 429 U.S. 816 (1976). This case presents an excellent opportunity for this Court to rule

dispositively on the presumption of reliance in circumstances involving a fraud on the market.

B. The presumption of reliance applies to cases involving half-truths.

Like *Mills*, *Affiliated Ute v. United States*, *supra*, created an exception to the general rule that the plaintiff must prove reliance in a Rule 10b-5 case. The plaintiffs in *Affiliated Ute* brought suit under Rule 10b-5 claiming that a bank and its employees had sold shares in a corporation with the intent of defrauding plaintiff sellers. This Court rejected the claim that individual proof of reliance was required under the Rule. The Court pointed out that although Rule 10b-5(b) prohibits material misstatements, Rule 10b-5(a) and (c) prohibit fraudulent devices, schemes, artifices or courses of business. In a case "involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery." 406 U.S. at 153. Rather, for the plaintiff to recover, "[a]ll that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision." *Id.* at 153-154.

Most courts – correctly in our view – have treated *Affiliated Ute* as an evidentiary ruling, establishing in cases governed by the decision a presumption of reliance upon a showing of materiality. *E.g.*, *Rochez Brothers, Inc. v. Rhoades*, 491 F.2d 402, 410 (3rd Cir. 1974); *Chelsea Associates v. Rapanos*, 527 F.2d 1266, 1271-1272 (6th Cir. 1975); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1048 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). The evidentiary purpose served by the *Affiliated Ute* rule seems clear. Proof that a plaintiff had in mind and relied

upon the opposite of omitted (and material) facts would be an almost impossible burden to discharge.

While recognizing that the *Affiliated Ute* presumption applies to cases involving a failure to disclose, the Court below rejected its applicability to cases involving a "failure to state a fact necessary to make those statements made not misleading . . . ." App. A-21, No. 81-680. The Court erred in excluding "half-truths" from the scope of the *Affiliated Ute* presumption. This exclusion does violence to the purpose served by the *Affiliated Ute* rule.

Half-truths present as severe an evidentiary hurdle for a plaintiff as do omissions in a Rule 10b-5 case. Although half-truths by definition involve the presentation of some information, what makes them half-truths is the omission of material facts. Conversely, the omission of a material fact from a prospectus creates a half-truth. It would be as difficult for a plaintiff to prove in a half-truth case that he had relied on the opposite of facts omitted from a half-truth as for a plaintiff in the *Affiliated Ute* situation to prove he had relied on the opposite of undisclosed facts.

Moreover, to distinguish for the purposes of the *Affiliated Ute* presumption between cases involving omissions and cases involving half-truths is to place an unnecessary and undue premium upon artful pleading. Virtually any case involving a material omission could be characterized as a half-truth case, and vice versa. Indeed, *Affiliated Ute* itself appears to have involved half-truths as well as omissions. The Court noted that "as to some of the petitioners, these defendants may have made no positive representation or recommendation," 406 U.S. at 153, indicating that as to others, the defendants did make representations or recommendations to injured sellers. As to the former group, the case involved a failure to disclose; for the latter, it involved half-truths.

In the case at bar, the jury found that Respondents had "failed to disclose" the costs of completing the speedway and the financial condition of the Company. App. A-4 & n. 2, No. 81-680. Each of these "failures to disclose" involves both a misrepresentation – the "truthful" part of the half-truth – and an omission – the omitted material necessary to make the half-truth a whole truth. It makes no sense for purposes of reliance to distinguish between fraudulent omissions and fraudulent half-truths, and this Court in *Affiliated Ute* did not do so. Under the rationale of *Affiliated Ute* the presumption of reliance should apply in Rule 10b-5 cases involving half-truths, as well as cases solely involving omissions.

The jury also found, as in *Affiliated Ute,* that Respondents Lopatin and Share had engaged in, and Respondent Herman & Maclean had aided and abetted, various fraudulent "transactions, acts, practices or courses of business." App. 5a-6a. Petitioners thus proved violations of both Rule 10b-5(b) and (c). When plaintiffs prove a scheme to defraud using half-truths, requiring in addition proof of individual reliance – that the defendants acted honestly and not fraudulently when they prepared the prospectus – serves no useful purpose. Under these circumstances the *Affiliated Ute* Court held that proof of reliance is unnecessary.

The courts of appeals of four circuits have upheld the presumption of reliance in cases involving half-truths; there is, therefore, a conflict among the circuits on this issue. *See Holmes v. Bateson,* 583 F.2d 542, 558 (1st Cir. 1978) (presumption of reliance may be used where purchasing shareholder in a close corporation portrays the corporate finances as "bleak," when in fact the cash flow is restricted but the company's future is sufficiently promising that the purchasing shareholder has entered into un-

disclosed and eventually successful negotiations for merger); *Sharp v. Coopers & Lybrand,* 649 F.2d 175, 187-189 (3rd Cir. 1981) (presumption of reliance in case involving both misrepresentations and reliance); *Chelsea Associates v. Rapanos,* 527 F.2d 1266 (6th Cir. 1975) (selling shareholder in a close corporation gives purchasers financial information, but fails to disclose that the company has lost its principal customers and contract and has negative working capital; presumption rebutted by purchaser's actual lack of reliance); *Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, Inc.,* 592 F.2d 409, 411-412 & n.1 (8th Cir. 1979) (presumption of reliance may be used where seller of stock of corporation holding patent license for seeds, refused to make warranty concerning corporation's continued ability to use seed subject to patent license, knowing that seed would be reclaimed by licensee upon sale of stock).

This Court should resolve that conflict and determine the applicability of *Mills* and *Affiliated Ute* in cases involving half-truths and fraud on the market.

III. The Decision of the Court below Requiring the Plaintiff to Prove in a Rule 10b-5 Case that He Exercised Due Care Conflicts with Decisions of the Courts of Appeals of Other Circuits.

Prior to this Court's decision in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), most courts had imposed a "due diligence" requirement on a Rule 10b-5 plaintiff. Proving that he had exercised due diligence, generally interpreted to mean the absence of negligent conduct, was a part of the plaintiff's case. *See, e.g., Dupuy v. Dupuy,* 551 F.2d 1005, 1016-1017 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977). So long as a pre-*Hochfelder* defendant could be

held liable for negligent conduct in a Rule 10b-5 case, it was reasonable to allow the contributory negligence of the plaintiff to bar relief. However, after this Court held in *Hochfelder* that Rule 10b-5 required proof that defendant had acted with scienter, most courts reevaluated the due diligence standard:

> If the negligence standard were being applied it might be appropriate to allow due diligence to be exacted from the victim, but where liability of the defendant requires proof of intentional misconduct, the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated.

Holdsworth v. Strong, 545 F.2d 687, 692 (10th Cir. 1976) (*en banc*), *cert. denied*, 430 U.S. 955 (1977).

Since *Hochfelder* the circuits have been divided on both the standard of plaintiff's care and who bears the burden of proof. *See Dupuy v. Dupuy*, 434 U.S. 911 (White, J., dissenting from denial of petition for writ of certiorari). Petitioners have no quarrel with the Fifth Circuit's substantive standard, followed by the Court below, which permits a plaintiff to recover unless his conduct is comparable to that of the defendant. *Dupuy v. Dupuy, supra*, 551 F.2d at 1019-1020.

Petitioners, however, do object to the decision that the plaintiff bears the burden to prove his own lack of culpability. First, since *Hochfelder*, a Rule 10b-5 plaintiff already bears the heavy burden of proving that the defendant acted intentionally. The remedial goals of the federal securities laws would be furthered by placing the burden on the defendant, who by hypothesis has acted with scienter, to show that despite his culpability he deserves to avoid liability. Second, as with reliance upon information

not disclosed, it is extremely difficult to prove a negative. Thus, it is better policy to place upon the defendant the affirmative case to prove that plaintiff acted recklessly. Finally, in the context of tort law, contributory negligence is normally an affirmative defense, the burden of which is borne by the defendant. W. Prosser, *Handbook of the Law of Torts* § 65 at 416 (4th ed. 1971). Since contributory negligence "clearly operate[s] to the advantage of the defendant, [it is] commonly regarded as [a] defense[ ] . . . to a tort which would otherwise be established." *Id.* The hardship of the contrary rule is "apparent." *Id.*

The contrary rule adopted by the Fifth Circuit and applied in the case at bar conflicts with decisions of the Third and Tenth Circuits, which have ruled that the defendant bears the burden of showing plaintiff's culpability. *Staub v. Varsman & Co., Inc.*, 540 F.2d 591, 598 (3rd Cir. 1976); *Holdsworth v. Strong, supra,* 545 F.2d at 693. The Fifth Circuit rule also conflicts with that of the Second Circuit, which places the burden on the defendant to raise the issue of plaintiff's culpability, although the plaintiff bears the burden of proof on that issue. *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 79 & n.10 (2d Cir. 1980), *cert. denied,* 49 U.S.L.W. 3531 (Jan. 26, 1981).

Because the Fifth Circuit's rule places an undue burden on Rule 10b-5 plaintiffs and because the circuits are in conflict on this question, this Court should review the issue of which party bears the burden of proving plaintiff's culpability.

IV. This Court Should Resolve Whether a Defendant in a Rule 10b-5 Case Should Be Entitled to a Right to Contribution.

The Fifth Circuit ruled that the trial court erred in denying Respondents the right to seek contribution against the underwriters and the principal contractor for the speedway who had settled with Petitioners prior to trial, and it held that an implied right to contribution exists in Rule 10b-5 cases. App. A-39-45, No. 81-680.

In two recent decisions, this Court held that in the absence of an express provision for contribution made part of a remedial statute, Congress did not intend to give federal courts the broad power to fashion a right to contribution. *Texas Industries v. Radcliff Materials, Inc.*, 68 L.Ed.2d 500 (1981) (section 1 of the Sherman Act, 15 U.S.C. § 1 and section 4 of the Clayton Act, 15 U.S.C. § 15); *Northwest Airlines, Inc., v. Transport Workers Union of America*, 67 L.Ed. 2d 750 (1981) (Equal Pay Act of 1963, 29 U.S.C. § 206(d) and Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e *et. seq.*). In both decisions, this Court distinguished lower federal court cases[10] that have found a right of contribution under the Securities Act of 1933 and the Securities Exchange Act of 1934, and it specifically left open the question whether contribution is available to an intentional tortfeasor under the securities laws. *Texas Industries, supra*, 68 L.Ed.2d at 508 n.11; *Northwest Airlines, supra*, 67 L.Ed.2d at 763 n.24.

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[10]*See, e.g.*, Heizer Corp. v. Ross, 601 F.2d 330 (7th Cir. 1979); Globus, Inc. v. Law Research Service, Inc., 318 F.Supp. 955 (S.D.N.Y. 1970), *aff'd.*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971).

Most state courts continue to deny contribution to a tortfeasor who acts willfully, on the ground that an intentional tortfeasor should not be aided by the courts and should not be permitted to bring a cause of action based on his intentional tort. *See generally Restatement (Second) of Torts,* § 886A(3) Comment j (1977); Uniform Contribution Among Tortfeasors Act § 1(c)(1955); W. Prosser, *Handbook of the Law of Torts* § 50 at 308 (4th ed. 1971). In light of *Ernst & Ernst v. Hochfelder, supra,* in which this Court held that a plaintiff in a Rule 10b-5 case must show that the defendant acted with scienter, this Court should review the issue whether a defendant in a Rule 10b-5 case – who is, by definition, an intentional tortfeasor – should be entitled to an implied right to contribution.

V. The Procedure By Which the Court below Determined State Law So Diverges from Accepted Practice that this Court Should Grant Review in Exercise of Its Supervisory Jurisdiction.

Petitioners are aware that this Court rarely reviews decisions of the lower federal courts interpreting matters of state law. However, the decision of the Fifth Circuit in this case – ignoring a controlling decision by the Texas Supreme Court in favor of a decision by a lower Texas Court – so diverges from accepted procedure that review by this Court is justified.

Petitioners asserted a pendent claim under section 33 of the Texas Securities Act, Art. 581-33 (A)(2), Tex. Rev. Civ. Stat. (Supp. 1963). That statute imposes liability on the part of "[a]ny person who . . . [o]ffers or sells a security . . . by means of any untrue statement of a material fact . . . [in favor of] the person buying the security from

him." App. 3b. Quoting from the decision of the highest civil court in Texas, the Texas Supreme Court, in *Brown v. Cole,* 291 S.W.2d 704, 708 (Tex. 1956), the trial court charged the jury with the meaning of "seller" under the Texas Act as meaning, *inter alia,* any person who "forms any link in the chain of the selling process or if he performs any act by which a sale is made." A-27, No. 81-680.[11]

The court of appeals reversed and held that the trial court should have directed a verdict in favor of Respondents. App. A-29, No. 81-680. Although the Court recognized that the term "seller" had been given a very broad meaning by the Texas Courts, App. A-27-28, No. 81-680, the Court below chose to ignore *Brown v. Cole* and relied instead upon the decision of a middle-level Texas appellate court in *Stone v. Enstam,* 541 S.W.2d 473 (Tex. Civ. App. 1976) (no writ). According to the Court below, *Stone* "limits the T[exas] S[ecurities] A[ct] to those who are actively engaged in the sale process and prevents it from reaching those who merely participate in preparing the offering." App. A-28, No. 81-680 (footnote omitted).

The interpretation of "seller" in *Stone* seems clearly wrong. The legislative history of the provision, prepared when section 33 was amended in 1963 states: "As originally submitted by the State Bar Committee on Securities and Investment Banking, new § 33 was substantially similar to the Uniform Securities Act Sec. 410. However, it omitted the subsection on 'Persons Liable' (on which *Brown v. Cole,* 155 Tex. 625, 291 S.W.2d 704, 59 A.L.R.2d 1011 (1956) *will continue to be authoritative* . . . ." (Emphasis

[11]The language in Brown v. Cole, relied upon by the trial court, is as follows: "As we interpret the Act the seller may be any link in the chain of the selling process or in the words of the Act he is one who performs 'any act by which a sale is made.'" 291 S.W.2d at 708.

added.) But what invites exercise of the supervisory power of this Court is not whether the Fifth Circuit's decision of what constitutes a "seller" is correct. Rather, it is the procedure followed by the Fifth Circuit in determining the authoritative state ruling on the question.

Under Texas state law, decisions of the Texas Civil Appeals courts are not binding on other courts unless the decision has been reviewed by the Texas Supreme Court. *E.g., Calvary Temple v. Taylor,* 388 S.W.2d 868, 871 (Tex. Civ. App. 1956); *Malone v. United States Fidelity & Guaranty Co.,* 9 S.W.2d 461, 463 (Tex. Civ. App. 1928). Because of its no writ history, *Stone v. Enstam* would not bind another Texas appellate court. *A fortiori, Stone* cannot overrule a decision by the Texas Supreme Court.

Ever since the landmark decision of *Erie R. Co. v. Tompkins,* 304 U.S. 64, 78 (1938), in matters governed by state law, "the law to be applied . . . is the law of the state. And whether the law of the state shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern."

Ascertaining state law when the highest court of the state has not spoken dispositively has sometimes proved a thorny issue. *Compare Fidelity Union Trust Co. v. Field,* 311 U.S. 169 (1940) (federal court bound by decision of lower state court that would not bind state appellate courts), *with Commissioner v. Bosch,* 387 U.S. 456 (1967) (federal court not necessarily bound by state appellate court decision). However, what has never been in dispute since *Erie* is that the interpretation of a state statute by that state's highest court is controlling on the federal courts. *E.g., O'Brien v. Skinner,* 414 U.S. 524, 531 (1974) ("it is not our function to construe a state statute contrary to the construction given it by the highest court of a

State"); *Landmark Communications, Inc. v. Virginia,* 435 U.S. 829, 837 n.9 (1978) (same); *Poulos v. New Hampshire,* 345 U.S. 395, 402 (1953) (interpretation of state statute by state court "is as though written into the ordinance itself").

The merits of the decision by the Fifth Circuit in the case at bar are sufficiently troubling that the Securities Commissioner of Texas took the unusual step of filing a brief amicus on the Texas Securities Act supporting Petitioners' petition for rehearing in the Court below.[12] However, the procedure by which the Fifth Circuit determined state law is so at variance with that prescribed by this Court that review is warranted.

CONCLUSION

For the foregoing reasons, the Court should grant the writ of certiorari.

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December, 1981

[12]A copy of the brief appears in Appendix C.

Appendix

81-1076

No. 81-

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IN THE

Supreme Court of the United States

October Term, 1981

RALPH E. HUDDLESTON and
CHESTER E. BRADLEY, Jr.,
individually and as designated Class Representatives *et al.*,
Petitioners,

v.

HERMAN & MACLEAN, LAWRENCE A. LOPATIN,
and LESLIE SHARE,
Respondents.

APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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APPENDIX A

CONFORMED COPY OF ANSWERS GIVEN BY THE JURY TO SPECIAL ISSUES SUBMITTED

SPECIAL ISSUE No. 1:

Do you find from a preponderance of the evidence that the TIS prospectus dated October 30, 1969 was materially misleading as to any one or more of the following:

Answer "Yes" or "No" as to each.

(a) The cost of purchasing land for and completing the facilities of the Texas Speedway identified in the Use of Proceeds section and to place those facilities in operation.

Answer: Yes.

(b) The working capital position of TIS on October 30, 1969.

Answer: Yes.

(c) The description of any obligation of American Raceways, Inc. to TIS.

Answer: No.

(d) The fulfillment of the conditions of the option to purchase shares of TIS stock by the Holloway Sand and Gravel Company.

Answer: No.

If you have answered "Yes" as to any section of Special Issue No. 1, you will answer the following Special Issue.

SPECIAL ISSUE No. 2:

Do you find from a preponderance of the evidence that in connection with the sale of the securities of TIS to plaintiffs during the period October 30, 1969, through January 28, 1970, any of the defendants with reckless disregard for the truth failed to disclose in the October 30, 1969, Registration Statement any one or more of the matters to which you have answered "Yes" in Special Issue No. 1, if any?

Answer "Yes" or "No" as to each defendant listed below as to each matter to which you have answered "Yes" in answer to Special Issue No. 1, if any.

	LoPatin	Share	Kawamoto	Margolian	H&M	Buchanan
(a)	Yes	Yes	No	No	Yes	No
(b)	Yes	Yes	No	No	Yes	No
(c)	___	___	___	___	___	___
(d)	___	___	___	___	___	___

SPECIAL ISSUE No. 3:

Do you find from a preponderance of the evidence that in connection with the sale of securities of TIS to plaintiffs during the period October 30, 1969, through January 28, 1970, defendant LoPatin and/or Share engaged in one or more of the following transactions, acts, practices or courses of business?

Answer "Yes" or "No" as to each.

(a) Caused the pro forma transactions that are part of the May 31, 1969, pro forma balance sheet in the October 30, 1969, Registration Statement to show that TIS would have $93,870.00 of cash available for general corporate

purposes after an allowance of $295,771.00 for funds to be used for general administrative expenses to the opening date of the Texas Speedway.

Answer: Yes.

(b) Caused Defendant Buchanan to execute a consent dated October 24, 1969, to allow its name to be used as an expert in the penultimate paragraph under the Use of Proceeds section in the fourth paragraph of the Plant and Property sections without requiring Buchanan to perform due diligence procedures to ascertain the accuracy of the cost estimates set forth therein.

Answer: Yes.

(c) Caused two supplements to the October 30, 1969, Registration Statement to be filed with the SEC and stickered on the prospectus, said supplements being dated November 12, 1969, and December 23, 1969, and stating certain information about the races run at the Texas Speedway on November 9, 1969, and December 27, 1969, without also stating in the supplements that the races had resulted in substantial losses to TIS due to lack of attendance and/or adverse weather conditions.

Answer: No.

(d) Caused TIS on October 21, 1969, to borrow $100,000.00 from Holloway Construction Company without disclosing in the October 30, 1969, Registration Statement that such borrowings had been obtained from a company affiliated with the principal contractor for the Texas Speedway.

Answer: Yes.

(e) Caused TIS during the period October 30, 1969, to January 28, 1970, to advance to American Raceways, Inc., funds in excess of $250,000.00 from the proceeds of the public offering instead of using those funds to pay outstanding construction costs of the Texas Speedway, administration costs to place the Texas Speedway in operation and expenses of the public offering.

Answer: Yes.

If you have answered any section of the preceding Special Issue "Yes," then you will answer the following Special Issue.

SPECIAL ISSUE No. 4:

Do you find from a preponderance of the evidence that as to any transaction, acts, practices or course of business to which you have answered "Yes" in Special Issue No. 3, if any, that said transactions, acts, practices or course of business were material facts as that term has been defined?

Answer "Yes" or "No" as to each section to which you have answered "Yes" in Special Issue No. 3, if any.

Answer:

(a) Yes
(b) Yes
(c) –
(d) Yes
(e) No

If you have answered any section of the preceding Special Issue "Yes," then you will answer the following Special Issue.

SPECIAL ISSUE No. 5:

Do you find from a preponderance of the evidence that as to any transaction, acts, practices or course of business which you have found to be "material facts," if any, in answer to Special Issue No. 4, that said transactions, acts, practices or course of business were engaged in by the defendant LoPatin and/or the defendant Share with intent to deceive or defraud?

Answer "Yes" or "No" as to each defendant and as to each section to which you have answered "Yes" in Special Issue No. 4, if any.

Answer:

	LoPatin	Share
(a)	Yes	Yes
(b)	No	Yes
(c)	— —	— —
(d)	Yes	Yes
(e)	— —	— —

If you have answered "Yes" as to any one or more of the sections of Special Issue No. 5, then answer the following Special Issue:

SPECIAL ISSUE No. 6:

Do you find from a preponderance of the evidence that one or more of the following defendants aided and abetted the unlawful conduct of the defendants LoPatin and/or Share, if any, in causing the transactions, actions, practices and course of conduct to occur which operated as a fraud or deceit upon the plaintiffs?

Answer "Yes" or "No" as to each of the following listed defendants:

Answer:

Kawamoto	No
Margolian	No
H & M	Yes
Buchanan	No

SPECIAL ISSUE No. 7:

Do you find from a preponderance of the evidence that one or more of the following defendants constituted a seller under the Texas Securities Act as that term has been defined to you with respect to the securities of TIS during the period October 30, 1969 through January 28, 1970?

Answer "Yes" or "No" as to each of the defendants listed.

Answer:

LoPatin	Yes
Share	Yes
Kawamoto	No
Margolian	No
H & M	Yes
Buchanan	Yes

SPECIAL ISSUE No. 8:

Do you find from a preponderance of the evidence that one or more of the following defendants, directors and officers of American Raceways, Inc. was a "controlling person" of TIS as that term has been defined?

Answer "Yes" or "No" as to each listed defendant.

Answer:

LoPatin	Yes
Share	Yes
Kawamoto	No

APPENDIX B

SECURITIES EXCHANGE ACT OF 1934

Section 10, 15 U.S.C. § 78j (1976)

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

RULE 10b-5

17 CFR § 240.10b-5 Employment of manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Texas Securities Act, Section 33

Art. 581-33.

A. Any person who

* * * * *

(2) Offers or sells a security (whether or not the security or transaction is exempt under Section 5 or 6 of this Act) by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made not misleading (when the person buying the security does not know of the untruth or omission, and who in the exercise of reasonable care could not have known of the untruth or omission) is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six per cent (6%) per year from the date of payment, less the amount of any income received on the security upon the tender of the security, or for damages if he no longer owns the security. Damages are the amount that would be recoverable upon a tender less (a) the value of the security when the buyer disposed of it and (b) interest at six per cent (6%) per year on such value from the date of disposition. Nothing herein shall prevent the award of punitive or exemplary damages in an amount not to exceed twice the actual damages, as found by the jury, when such false representation or omission is proven to be willfully made.

APPENDIX C

No. 79-3712

* * *

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

* * *

RALPH E. HUDDLESTON AND CHESTER E. BRADLEY, JR., INDIVIDUALLY AND AS DESIGNATED CLASS REPRESENTATIVES,
Plaintiffs-Appellees

v.

HERMAN AND MACLEAN, ETC., ET AL.,
Defendants

HERMAN AND MACLEAN, CERTIFIED PUBLIC ACCOUNTANTS, A PARTNERSHIP, AND LAWRENCE A. LOPATIN AND LESLIE SHARE,
Defendants-Appellants.

* * *

Appeal From The United States District Court
For The Northern District Of Texas

* * *

MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF

TO THE HONORABLE JUDGES OF SAID COURT:

Pursuant to Rule 29 of the Federal Rules of Appellate Procedure, Richard D. Latham, Securities Commissioner of the State of Texas, represented herein by Mark White, Attorney General of Texas, files this his Motion For Leave To File Amicus Curiae Brief and as grounds therefore would show unto the Court as follows:

I.

This Panel in its decision of March 9, 1981, in the above entitled and numbered lawsuit, held that Lawrence Lopatin, Leslie Share and Herman and Maclean, Inc. (hereinafter "Defendants"), the corporate officers and accountants who prepared the prospectus of Texas International Speedways, Inc., in connection with a securities offering, were not sellers of those securities under the Texas Securities Act. In making such ruling, this panel interpreted Texas law as to the definition of a "seller" under the Texas Securities Act. Richard D. Latham, as Securities Commissioner of the State of Texas, respectfully requests that the Court rehear this matter on the grounds that the definition of "seller" in the Texas Securities Act is broader than held by this Panel and would encompass the above individuals who prepared the prospectus.

II.

The Securities Commissioner for the State of Texas has a direct interest in the interpretation of the Texas Securities Act and, as the chief enforcement officer of the Texas Securities laws, has an expertise in the interpretation and application of the Act which would be of benefit to this Court.

III.

The issue which the Commissioner's *amicus* brief addresses is the interpretation of a seller under the 1963 Amendment to Section 33 of the Texas Securities Act. This issue is not moot for future application of the Act, notwithstanding the 1977 Amendment to Section 33 of the Act to clarify the scope of Section 33 as to the definition of "seller" under the Act. Sections 29 and 32 of the Texas Securities Act relating to penal sanctions and injunctive relief against violators of the Act still rely upon the pre-1977 definition of a "seller" to determine their scope. Consequently the pre-1977 definition of a "seller" will continue to be important for the future enforcement of the injunctive and penal sections of the Act.

WHEREFORE, PREMISES CONSIDERED, Richard D. Latham, Securities Commissioner for the State of Texas, respectfully requests that the Honorable Judges of this Panel grant his Motion for Leave to File Amicus Curiae Brief for the consideration of these matters, and for such other relief, general or special, legal or equitable, to which he may show himself justly entitled.

Respectfully submitted,

MARK WHITE
Attorney General of Texas

JOHN W. FAINTER, JR.
First Assistant Attorney General

RICHARD E. GRAY, III
Executive Assistant Attorney General

THOMAS M. POLLAN
Assistant Attorney General

No. 79-3712

* * *

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

* * *

RALPH E. HUDDLESTON AND CHESTER E. BRADLEY, JR., INDIVIDUALLY AND AS DESIGNATED CLASS REPRESENTATIVES,
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Defendants-Appellants.

* * *

Appeal From The United States District Court
For The Northern District Of Texas

* * *

AMICUS CURIAE BRIEF ON BEHALF OF RICHARD D. LATHAM, SECURITIES COMMISSIONER OF TEXAS IN SUPPORT OF MOTION FOR REHEARING

* * *

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No. 79-3712

* * *

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

* * *

RALPH E. HUDDLESTON AND CHESTER E. BRADLEY, JR., INDIVIDUALLY AND AS DESIGNATED CLASS REPRESENTATIVES,
Plaintiffs-Appellees

v.

HERMAN AND MACLEAN, ETC., ET AL.,
Defendants

HERMAN AND MACLEAN, CERTIFIED PUBLIC ACCOUNTANTS, A PARTNERSHIP, AND LAWRENCE A. LOPATIN AND LESLIE SHARE,
Defendants-Appellants.

* * *

Appeal From The United States District Court
For The Northern District Of Texas

* * *

AMICUS CURIAE BRIEF ON BEHALF OF RICHARD D. LATHAM, SECURITIES COMMISSIONER OF TEXAS IN SUPPORT OF MOTION FOR REHEARING

* * *

TO THE HONORABLE JUDGES OF SAID COURT:

Pursuant to Rule 29 of the Federal Rules of Appellate Procedure, Richard D. Latham, Securities Commissioner of the State of Texas, represented herein by Mark White, Attorney General of Texas, files this his brief as amicus curiae.

ISSUES PRESENTED

The Court in its order of March 9, 1981, in the above numbered and entitled lawsuit, held that Lawrence LoPatin Leslie Share and Herman and MacLean, Inc. (hereinafter "defendants"), the corporate officers and accountants who prepared the prospectus of Texas International Speedways, Inc., in connection with a securities offering, are not sellers of those securities under the Texas Securities Act. Richard D. Latham respectfully requests that this Court rehear this question and would show unto the Court that such individuals are sellers under the Texas Securities Act.

ARGUMENT AND AUTHORITIES

1. Defendants are "sellers" under the 1963 amendments to Section 33 of the Texas Securities Act.

   A. *Brown v. Cole* states the applicable test for determining a "seller" under the 1963 amendment to Section 33 of the Texas Securities Act.

The securities transactions complained of in plaintiffs' petition occurred while the 1963 amendments to the Texas Securities Act were in effect. The legislative history of Section 33 prepared by the Section of Corporation, Banking

and Business Law of the State Bar of Texas stated the authoritative standard for determining which individuals would be liable as seller under the Act as follows:

> *Legislative History.* As originally submitted by the State Bar Committee on Securities and Investment Banking, new section 33 was substantially similar to the Uniform Securities Act sec. 410. However, it omitted the subsection of "Persons Liable" (on which *Brown v. Cole,* 155 Tex. 625, 291 S.W.2d 704, 59 A.L.R.2d 1011 (1956) will continue to be authoritative) and the provision for recovery of attorneys' fees by successful plaintiffs.

As set forth in the comments, the intent of the legislature was to continue to use the *Brown v. Cole* rule regarding the scope of the definition of a seller who would be liable under Section 33, notwithstanding the changes that had been made in the section by the 1963 amendments.

B. Defendants-Appellants are "sellers" under the *Brown v. Cole* rule.

The Texas Supreme Court in *Brown v. Cole,* 291 S.W.2d 704 (Tex. 1956) looked to the broad definition of "sale" in the Act to define the Act's scope of a "seller" who would be liable under the Act's civil liabilities section for failure to register or misrepresentation and fraud in the sale of securities. As a result, the court formulated the following rule:

> "As we interpret the Act, the seller may be any link in the chain of the selling process or in the words of the Act, he is one who performs 'any act by which a sale is made'."

This rule has been given an extremely broad interpretation by the Texas Courts. In one example cut of many, the court in *Christie v. Brewer,* 374 S.W.2d 908 (Tex.Civ.App. - Austin 1964, writ ref'd n.r.e.), found that a corporate executive officer was a seller of the corporation's securities even when the only act taken by her was confirming a sale to the appellee. The court reasoned that this was a link in the selling process and that it was immaterial that the officer did not solicit the sale, since there was participation in a sale that was solicited. The defendants would clearly come within the breadth of this rule. As the preparers and signers of the prospectus, they were a major link in the selling process, even though they did not directly solicit the sale, since the prospectus is the most important vehicle for the transmission of information about the corporation to prospective buyers of the securities.

C. *Stone v. Enstam* did not limit the scope of the *Brown* rule.

The primary case which found that an individual who was a link in the selling process in a securities transaction was not a seller is *Stone v. Enstam,* 541 S.W.2d 473 (Tex.Civ.App. – Dallas 1976, no writ). However, *Stone,* as a result of its "no writ" history, has no precedential value under Texas law, particularly when it attempts to limit or modify a rule formulated by the Texas Supreme Court.

Moreover, the court in *Stone* attempted to limit the extent of the holding in *Brown* by limiting the *Brown* rule to its facts with the result that a "seller" would be defined as an active negotiator for the sale of securities. This restrictive view of the *Brown* rule has not been endorsed by any other Court of Civil Appeals whose decision has been reviewed by the Texas Supreme Court. Therefore, the *Stone* case must be viewed as being in conflict with the

other Texas decisions interpreting the *Brown* rule and should not be followed by this Court.

Finally, the reasoning behind the *Stone* case would not be applicable to the facts of the case at bar. The court in *Stone* found that its facts differed significantly from *Brown,* since the defendant in *Stone* did not act as an agent on behalf of any party to the transaction and gratuitously volunteered to act as a finder of a seller for the purchaser. The court apparently felt that it was the lack of a partisan relationship with the seller regarding the terms of the sale which rendered the defendant non-liable as a disinterested party to the sale. This was similar to the situation in *Herren v. Hollingsworth,* 167 S.W.2d 735 (Tex. 1943), where the defendant was considered to be merely a finder of a potential oil driller/oil lease purchaser and not a part of the interaction between the seller and purchaser in determining the price or other terms of the oil lease. However, in the case at bar, the corporate officers who would benefit, directly or indirectly, from the sale of the securities were involved in the preparation of the prospectus for the sale of the securities. They were not gratuitously offering their help to the corporation and their efforts were intimately a part of the terms and conditions of the sale of the securities to the general public. Although the courts have not been required to reach the outer parameters of the *Brown* rule, a president and vice-president who prepare and sign a prospectus would certainly be within the limits of the rule as the authors of the most important document for the transmission of information about the securities offering. The preparation of the prospectus is one of the most critical "links" in the process of the sale, since it is the document by which most investors obtain information about the securities they will be buying.

2. The 1963 amendments to Section 33 of the Texas Securities Act did not exclude defendants from liability as "sellers".

A. The 1963 amendments did not limit the scope of the *Brown* rule.

The Comments to the 1963 Amendments of Section 33 of the Texas Securities Act specifically state that the "Persons Liable" subsection of Section 410 of the Uniform Securities Act was omitted from the Amendments and, thus, the *Brown v. Cole* rule would be authoritative as to the persons liable under the Act. This legislative history clearly indicates that *Brown v. Cole* was to continue in force, notwithstanding any changes that had been made in Section 33 by the amendments.

Even Professor Bromberg, the strongest critic of the *Brown* rule and the author of the Comments to the 1977 amendments, states:

> 'Old § 33A allowed recovery only from 'any person who sells'. *Although the phrase would presumably be broadly construed,* see Brown v. Cole, 155 Tex. 625, 291 S.W.2d 704 [9 A.L.R.2d 101] (1956), its scope was unclear, particularly since the 1963 language could be read as narrower than the prior language interpreted in Brown v. Cole." Comments, 1977 Amendments, art. 581-33, TEX.REV.CIV.STAT.ANN. (Supp. 1980-81). (Emphasis added).

This court should follow other Texas courts and the presumption stated in Professor Bromberg's comments to give Section 33 a broad construction under the *Brown v. Cole* rule which would encompass defendants as sellers.

B. Even if the 1963 amendments "narrowed" section 33, the defendants would still be liable under the *Brown* rule to purchasers in the primary or secondary markets.

The 1963 amendments to section 33A(1) provide, in pertinent part:

> A. any person who
>
> * * *
>
> (2) offers or sells a security (whether or not the security or transaction is exempt under section 5 or 6 of this Act) by means of any untrue statement of the material fact or any omission to state a material fact necessary in order to make the statements not misleading (when the person buying the security does not know of the untruth or omission, and who in the exercise of reasonable care could not have known of the untruth or omission) is liable to the person buying the security from him, who may sue either at law or in equity . . . .

Professor Bromberg has argued that the 1963 amendments "narrowed" the language of Section 33 by the inclusion of a "privity" provision that a seller is liable to the person buying the security from him. *Bromberg, Civil Liabilities under Texas Securities Act, § 33 (1977) and Related Claims,* 32 Sw. L.J. 867, 910 n. 109 (1978). However, the legislative history of the 1963 amendments also states that *Brown v. Cole* is the authoritative definition of a seller under § 33. Even if the "narrow" interpretation of § 33 were accepted, the privity provision and the *Brown* rule must be read together. *Brown v. Cole* can be harmonized with the "narrow" interpretation of the 1963 amendments

by the interpretation that although § 33 was given a privity provision, it was not a "strict" privity provision. Thus, even though the purchaser and seller must be related to the same sale, the "seller" under § 33 can be anyone who was a link in the selling process or who performed an act by which the particular sale to the plaintiff-purchaser was made. Consequently, under the 1963 amendments, although a purchaser could not sue a seller who was not related to the particular sale of the security to him, as he could have done under the 1941-1963 statute, he was not precluded from suing anyone who had performed any act by which the sale of securities was made to him, even if that person was not in strict privity.

The preparation of, and information contained in, the prospectus would be a link in the selling process of each sale of a security whether in the primary or secondary market, since it is a document addressed to, and is for the benefit of, the general public to enable the public to evaluate the value of the securities sold. A purchaser in the primary market directly relies upon the prospectus as to the financial condition of the corporation. In the case at bar, the corporation was required to offer its securities through prospectus to all purchasers during the original offering under § 9 of the Texas Securities Act. In addition, the class certified by the trial court included all persons who purchased securities within 90 days of the original offering. Under federal securities law, all such purchasers must be given a copy of the prospectus prior to or at the time of the sale. 15 U.S.C. §§ 77(d)(3), 77(e)(b)(2). Therefore the prospectus was a crucial link in the selling process to the plaintiff class at bar. A purchaser in the secondary market either directly relies upon the prospectus or relies upon the fact that the market value of the security reflects the value and financial condition of the corporation set

out in the information contained in the prospectus. All persons who prepare and sign the prospectus are performing an act by which the sale is made. Therefore, even under the narrow view of the 1963 amendments, *Brown v. Cole* would still require the holding that the corporate officers who prepared, signed, and misrepresented the company's financial condition in the prospectus are sellers under the Act and liable to the plaintiffs. To interpret the Act otherwise would reach the anomalous and unjust result that a dealer or salesman who had no knowledge as to the accuracy of the prospectus would be liable for the misrepresentations in the prospectus while individuals who prepared the prospectus would not be liable under Texas law.

3. Federal law should not govern the 1963 amendments to § 33 of the Texas Securities Act.

In the Comments to the 1963 Amendments to § 33 of the Texas Securities Act, the legislative history explicitly states that although § 33 was generally modeled after Section 410 of the Uniform Securities Act, significant differences existed in the Texas Act which was finally enacted. Specifically, the "Persons Liable" section was omitted and *Brown v. Cole* was stated to remain the authoritative statement of who was a seller under § 33. Therefore, § 12 of the U.S. Securities Act, 15 U.S.C. § 77*l*, derived from § 410 of the Uniform Securities Act, would not be analogous to § 33. Further federal cases interpreting § 12 of the U.S. Securities Act would not be appropriate guides for the interpretation of the 1963 amendments to § 33 of the Texas Act. Due to the difference in the statutes, Texas law should be controlling as to the interpretation of the Texas statute.

CONCLUSION

For the reasons set out above, the State of Texas files this amicus curiae and prays that this Court grant the appellees' motion for rehearing; and that upon rehearing, the opinion heretofore entered be withdrawn or modified as to its holding regarding the Texas Securities Act and judgment be entered affirming the decision of the federal district court as to the Plaintiffs-Appellees' cause of action under the Texas Securities Act or in the alternative that this Court refrain from ruling that corporate officers and accountants who prepare and sign a prospectus in connection with a securities offering are not sellers of those securities under the Texas Securities Act.

Respectfully submitted,

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Opposition

1

Office - Supreme Court, U.S.
FILED
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No. 81-1076

IN THE

Supreme Court of the United States

October Term 1981

RALPH E. HUDDLESTON AND CHESTER E. BRADLEY,
individually and as class representatives,
Petitioners,

v.

HERMAN & MACLEAN, LAWRENCE A. LOPATIN,
AND LESLIE SHARE,
Respondents.

BRIEF IN RESPONSE TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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February 26, 1982

QUESTIONS PRESENTED FOR REVIEW

1. Is the clear and convincing standard the appropriate burden of proof in private rule 10b-5 actions?

2. Does the instant case present claims based either on fraud on the market or half truths, and, if so, must individual reliance be proved in private rule 10b-5 actions involving fraud on the market or half truths?

3. Must a plaintiff, in establishing reliance on misrepresentations in a rule 10b-5 case, demonstrate that his reliance was reasonable?

4. Is a defendant in a lawsuit arising out of a registered offering of securities barred from obtaining contribution as a result of the plaintiff's election to sue under rule 10b-5 rather than under § 11 of the Securities Act of 1933?

5. Did the court below correctly apply state court authorities in construing the applicable provisions of the Texas Securities Act?

PARTIES BELOW

Plaintiffs — appellees in the Court of Appeals were Ralph E. Huddleston and Chester E. Bradley, Jr., individually and as designated class representatives of a class consisting of purchasers of securities of Texas International Speedway, Inc., during a ninety-day period commencing with the effective date of a registration statement pursuant to which such securities were issued. The defendants — appellants were Lawrence A. LoPatin, Leslie Share, and Herman & MacLean, certified public accountants.

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In The

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BRIEF IN RESPONSE TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

OPINIONS BELOW

The opinions below are described in, and are reproduced in the Appendix to, this Respondent's petition for a writ of certiorari (No. 81-680) (for convenience referred to herein as the "Defendant's Petition").

JURISDICTION

The jurisdictional basis for this Court's review of the decision of the Court of Appeals for the Fifth Circuit is described in the Defendant's Petition, in the Petitioners' response thereto, and in the cross petition to which this response is directed (hereinafter referred to as the "Cross Petition").

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations are reproduced in the appendix to the Cross Petition.

STATEMENT OF THE CASE

This Respondent's statement of the case is set forth in the Defendant's Petition.

ARGUMENT

General Observations

The Plaintiffs have sued under § 10(b) of the Securities Exchange Act of 1934.[1] The Cross Petition asks this Court to review four issues regarding the trial of § 10(b) lawsuits and a fifth issue regarding the Fifth Circuit's construction of the private remedies provisions of the Texas Securities Act as in effect in 1969. The Defendant's Petition presents only the threshold issue whether the plaintiffs indeed have a remedy under § 10(b).

If the Court wishes to consider any or all of the § 10(b) issues presented by the Cross Petition, we believe that the Court should first consider the threshold issue presented in Defendant's Petition.[2] If both Defendant's Petition and the Cross Petition are granted, the Court's disposition of the threshold issue may moot its consideration of the remaining issues.

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[1]While the principal thrust of plaintiffs' case is predicated on § 10(b) and Rule 10b-5, the pleadings allege also a violation of § 17(a) of the Securities Act of 1933 and a pendent claim under the Texas Securities Act. The § 17(a) claim was not addressed by the court below, but that portion of the district court judgment based on alleged violations of the Texas Securities Act was reversed. The grounds of the reversal would preclude further proceedings regarding that claim, unlike the claims under § 10(b) as to which the district court judgment was reversed and remanded.

[2]The question presented in Defendant's Petition is whether, assuming the existence of implied remedies generally under § 10(b),

Even if the plaintiffs' issues are not mooted by the Court's disposition of the jurisdictional issue and even if the plaintiffs prevail on each of the § 10(b) issues presented by them, the judgment of the Fifth Circuit would be unaffected. The reversal of the judgment entered by the district court is predicated on errors found by the Fifth Circuit which go beyond any of the questions presented in the Cross Petition. For example, the Fifth Circuit held that loss causation is an element of a § 10(b) action which must be established independently of the element of reliance and that loss causation is not proved by a showing of *material* misrepresentations or omissions.[3] (Defendant's Petition, App. A-25) The Fifth Circuit also found errors in the admission and in the exclusion of evidence, in the measure of damages employed by the district court, and in the awarding of attorneys' fees. Each of these holdings would require

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such a remedy exists on behalf of purchasers of registered securities who have an express remedy under § 11 of the Securities Act of 1933. The plaintiffs acknowledge in their response to the Defendant's Petition that the instant case "presents a good vehicle" for the consideration of this issue.

[3]The clearest discussion on the effect on proving loss causation of the decisions in *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970), and *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), is found in Mr. Justice Blackmun's concurring opinion in *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977). Although Judge Rubin's opinion does not cite *Chris-Craft*, his holding on the loss causation issue is directly in line with the following rationale expressed by Mr. Justice Blackmun:

> *Affiliated Ute Citizens*, of course, did not abolish the requirement of causation in failure-to-disclose cases. It simply provided the causal link between the omission of material information and the shareholder's act of purchasing or selling stock.

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remand as to all or a portion of the lawsuit, but none of these issues is presented in the Cross Petition.

This Court has historically been reluctant to grant certiorari where the proceedings below have not reached a conclusion. *Hamilton Shoe Co.* v. *Wolf Brothers*, 240 U.S. 251, 258 (1916); *Brotherhood of Locomotive Firemen and Enginemen* v. *Bangor & Aroostook Railroad*, 389 U.S. 327, 328 (1967).

In *Trans World Airlines, Inc.* v. *Hughes*, 449 F.2d 51, at 58 (2d Cir. 1971) *rev'd sub nom. Hughes Tool Company* v. *Trans World Airlines, Inc.*, 409 U.S. 363 (1973), the court of appeals characterized an earlier remand judgment as not a "final judgment" for purposes of determining its *res judicata* effect and the characterization was accepted by this Court, 409 U.S. 363, 364 n. 1.

We do not suggest that this Court may not grant certiorari to review a remand judgment. It may grant certiorari as to a case pending in a court of appeals before rendition of any judgment whatever, 28 U.S.C. § 1254(1). We suggest only that where the issues presented in a petition for certiorari may vary in contextual significance as a result of a new trial and a new appeal, this Court has in the past considered this possibility in determining whether to grant certiorari.

In addition, the offeror must show that the shareholders' reactions to the misstatements or omissions caused the injury for which it demands remuneration. Even though the *Mills-Affiliated Ute Citizens* presumption satisfies the requirements for proof of the first element of causation, the absence of any evidence that the violations might have altered the outcome of the contest for control would leave me unable to hold that the securities law violations caused the disappointed contestant's ultimate injury – its failure to acquire control of the target corporation.

430 U.S. at 51.

Of course, the judgment of the Fifth Circuit in the present case is no less a remand judgment as to the defendants. The Defendant's Petition presents, however, a fundamental jurisdictional issue which is unlikely to be treated differently following remand. Accordingly, the disposition of the question presented by the Defendant's Petition not only would permit the resolution of an issue of importance generally in securities litigation, it may obviate the need for further proceedings in this case.

The Standard of Evidence

The first question presented in the Cross Petition is the standard of proof applicable to private § 10(b) damages actions. The Fifth Circuit held that the correct standard is the "clear and convincing" standard rather than the "preponderance of the evidence" standard. (Defendant's Petition, App. A-17) This result was based on the considerations that (i) "judgment for the plaintiff detracts from a defendant's reputation to a far greater extent than in other civil litigation" and (ii) proof of intent to deceive is often a matter of inference. (Defendant's Petition, App. A-17 n.19) The former concept is reflected in this Court's holding in *Addington* v. *Texas,* 441 U.S. 418 (1979), where it observed:

> One typical use of the standard is in civil cases involving allegations of fraud or some other quasi-criminal wrongdoing by the defendant. The interests at stake in those cases are deemed to be more substantial than mere loss of money and some jurisdictions accordingly reduce the risk to the defendant of having his reputation tarnished erroneously by increasing the plaintiff's burden of proof. Similarly, this Court has used the "clear, unequivocal and convincing" standard of proof to protect particularly important individual

> interests in various civil cases. See, *e.g.*, *Woodby* v. *INS*, *supra*, at 285, 87 S.Ct., at 487 (deportation); *Chaunt* v. *United States*, 364 U.S. 350, 353, 81 S.Ct. 147, 149, 5 L.Ed.2d 120 (1960) (denaturalization); *Schneiderman* v. *United States*, 320 U.S. 118, 125, 159, 63 S.Ct. 1333, 1336, 1353, 87 L.Ed. 1796 (1943) (denaturalization).

441 U.S. at 424.

The linchpin of Petitioner's argument is the assertion made in the Cross Petition that the opprobrium to a defendant from an adverse result in a private § 10(b) proceedings fails to warrant invoking the clear and convincing standard. The Respondent is a small firm of certified public accountants. The effect on its reputation of a fraud judgment predicated on findings that it acted with intent to deceive or defraud investors would be ruinous. In applying the requirements of rule 9(b), Fed. R. Civ. Proc., to accountants alleged to have violated the federal securities laws, the courts have recognized that "rule 9(b)'s purpose, in part, is to protect the reputations of accountants and other professionals in fields of expertise which are sensitive to claims of fraud." *Gilman Brothers, Inc.* v. *Peat, Marwick, Mitchell & Co.*, CCH Fed. Sec. L. Rept. ¶ 96,512 (S.D.N.Y. 1978). The same considerations are relevant to the selection of the standard of proof applicable in § 10(b) cases.

Of even greater significance to the consideration of an appropriate standard is the recognition by the court below that inferences will support a scienter finding. Although the court held that a clear and convincing standard should have been applied, it also held that the evidence was sufficient under that standard to permit, but not to compel, a finding that each defendent acted with intent to deceive.

(Defendant's Petition, App. A-18) The court below supported its holding as to this Respondent by references to "expert testimony that H&M was, to some degree, negligent in its accounting procedures" (Defendant's Petition, App. A-18), to this Respondent's "involvement" in the preparation of the Use of Proceeds section of the prospectus (which was not covered by its auditor's report and therefore was not a basis for liability under § 11 of the Securities Act of 1933), and to this Respondent's refusal to give a comfort letter to the underwriters as to costs required to complete construction of the project to be financed by the proceeds of the offering, a matter clearly beyond the competence of accountants and auditors.

If this Court's holding in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), may be satisfied under a clear and convincing standard by so insubstantial a body of evidence, one hesitates to imagine the quality of evidence necessary to establish scienter under a preponderance of the evidence standard. Relevant to this issue is the broader question, not raised in Defendant's Petition but which this Court may nonetheless wish to consider, of the resolution by the court below of the issue left open in footnote 12 of the *Hochfelder* opinion "whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." 425 U.S. at 194 n. 12. Compare the liberal application of the recklessness standard by the court below with the much more rigorous application in *McLean* v. *Alexander*, 599 F.2d 1190 (3d Cir. 1979).

Reliance: Market Fraud and Half Truths

The Cross Petition asks this Court to consider the application of the reliance requirement to market fraud and to half-truths. Whether or not these questions are appropriate for this Court's consideration, the present case is

not a suitable vehicle for either. The plaintiffs tried the lawsuit and advocated special interrogatories on the assumption that a finding of materiality subsumes a finding of reliance. As the court below observed: "The district court, induced by counsel, confused materiality with reliance." (Defendant's Petition, App. A-23)

There is nothing in the record below of market fraud.[4] The Cross Petition attempts to circumvent this problem by referring to a finding of the district court that rule 10b-5 was violated by the Respondent's failure to give notice of the insolvency of TIS and by alleging that with this information, "the underwriters would have withdrawn or substantially revised the offering." (Cross Petition, p. 14) The problem is that the district court found that the failure to give notice of the insolvency of TIS occurred after the class period. (Defendant's Petition, App. C-3) The class period ended on January 28, 1970. The underwriters' decision to proceed with the offering of TIS securities was perforce made prior to the effective date of October 30, 1969. The Securities and Exchange Commission in its brief *amicus curiae* supporting the plaintiffs' petition for rehearing below avoided taking a position on the application of market fraud to the record in this case.[5]

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[4]The market fraud issue, although raised by plaintiffs both in their initial briefs and in the briefs accompanying their petition for rehearing and discussed by the Securities and Exchange Commission in its *amicus* brief in support of the plaintiff's petition for rehearing, was not discussed in either of the opinions below. This Court has normally declined to consider legal issues not covered by a lower court opinion. *N.L.R.B.* v. *Sears, Roebuck & Co.*, 421 U.S. 132, 163-164 (1975); *Ramsey* v. *Mine Workers*, 401 U.S. 302, 312 (1971).

[5]In its *amicus* brief the S.E.C. stated:

As *amicus curiae*, we express no views on whether the record

When this Court ruled in *Affiliated Ute Citizens of Utah* v. *United States*, 406 U.S. 128 (1972) that in a proper case the withholding of a material fact is sufficient to establish causation in fact, 406 U.S. at 153-154, it opened a Pandora's box which has never been closed. The Court did not reckon with the ingenuity of counsel to convert every securities fraud case into an omissions case, since every misrepresentation is susceptible of correction by a further disclosure and every misrepresentation produces consequences which are not disclosed. For example, the fraud charged to the defendants in this case is an underestimate of the cost of completing construction of an automobile raceway facility. Since an estimate was given, one would think that this case presents as unlikely a candidate as could be imagined for application of the *Affiliated Ute* doctrine. The plaintiffs argue, however, that when one estimates that construction costs will be, say, $4 million, if the actual costs prove to be greater he has also omitted to disclose the excess costs.

Further, plaintiffs argue that when the additional costs are translated into entries to a pro forma financial statement, failure to disclose the alleged consequences is a

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in this case adequately supports application of that rule of causation-in-fact [fraud on the market] in this case.

The Commision also acknowledged the correctness of the decision of the court below on the loss causation issue:

> Of course, as noted earlier, causation-in-fact is not the only causation requirement. As the panel recognized, proximate cause must be shown. Accordingly, even though an offering by the issuer would not have taken place if the true facts had been stated in the prospectus, a purchaser could not recover for a loss in value of the security which is not a reasonably foreseeable consequence of the defendant's deception – for example, a loss resulting from an unexpected natural disaster where the deception related to the company's earnings.

material omission. Thus, the insolvency argument runs to the effect that if the undisclosed additional costs had been factored into the pro forma financial statements, the issuer would have been shown to be insolvent and failure to disclose this insolvency was a material omission justifying the invocation of *Affiliated Ute* — an argument which is long on sophistry and short on sense. The argument proves too much. In establishing the exception, it destroys the rule. Although we would not deny that the *Affiliated Ute* principle could stand some patching, we do not believe the present case provides a suitable opportunity to do so.

The final point to be made concerning the reliance issue is that the problems confronting the plaintiffs in establishing reliance could easily have been avoided if plaintiffs had timely sued under § 11 of the Securities Act of 1933. No reliance requirement exists as to § 11 claimants, except for those buying following the publication of an earning statement for a period of at least twelve months beginning after the effective date of the registration statement pursuant to which the offering is made. Since no class member in the present case is such a purchaser, no reliance requirement would have existed with respect to any § 11 claim.

Plaintiffs' Due Care

As part of its discussion on reliance, the court below held that each member of plaintiff class must not only demonstrate reliance, he must show that the reliance was reasonable.

> Although our prior decisions have not been completely clear on this point, we think 'reasonable reliance,' the test referred to by the *Simon* court, contemplates a subjective reliance standard, tempered by the requirement of due diligence on the part of the plaintiff,

> rather than the objective reliance test applicable under the justifiable reliance concept. [Citations omitted.]

(Defendant's Petition, App. A-22)

This holding must be read in conjunction with the parallel holding on proving reliance in § 10(b) class actions.

> Consequently, in a class action, while the materiality element can be established for the class as a whole, reliance, like damages, is a matter of individual proof. *See* 5 A. Jacobs, The Impact of Rule 10b-5 § 64.01 [b][ii] (Supp. 1980).

(Defendant's Petition, App. A-23)

Plaintiffs do not raise for consideration by this Court the holding that reliance is a plaintiff's issue which must be established on an individual basis in a class action, which is surely the primary holding on proving reliance of the court below. They challenge only the secondary holding that in considering the subjective reliance of each class member, the court will temper its consideration of the evidence by reference to the due diligence of the individual. It is difficult to perceive in these murky waters the precise intent of the court below, but we submit that the effort was to strike a balance between a subjective and an objective approach to determining reliance. For an interesting discussion which reveals the difficulties encountered by the lower courts in dealing analytically with the issue of reliance, particularly in class action litigation, see Note, The Reliance Requirement in Private Actions Under Rule 10b-5, 88 Harv. L. Rev. 584 (1975).

We do not believe that the arcane subholding of the court below on proving reliance is a suitable question for this Court, particularly when presented in the review of a remand judgment.

Contribution

The court below followed the clearly defined pattern of the lower federal courts in holding that contribution is available among joint participants in transactions found to have violated § 10(b). (Defendant's Petition, App. A-39-45) Because of the manner in which it was presented, the contribution issue is a specious issue in the present case. None of the defendants has asked for contribution.[6] The plaintiff class, in its motion for judgment, asked for a ruling that the defendants were barred from seeking contribution from persons who were not then parties to the litigation and as to whom a contrary ruling would presumably have had no effect. The district court nevertheless complied with plaintiffs' request. (Defendant's Petition, App. C-7)

Since the holding was there for whatever effect it might have on the defendants, the contribution issue was briefed and argued to the Fifth Circuit, whose holding was as stated above. Notwithstanding, we submit that this Court may wish to reserve this question for an occasion on which the contribution question is at issue as between parties before the Court.

One further point of interest regarding the contribution issue is its bearing on the implied remedy question raised in Defendant's Petition. It has been the premise of all courts which have found a § 10(b) remedy to coexist with a remedy under § 11 that the *procedural* safeguards lost

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[6]When the underwriters and their attorneys settled with the plaintiff class and before they were dismissed from the lawsuit, certain of the remaining defendants filed motions for leave to amend their pleadings to assert cross claims for contribution. These motions were denied without prejudice to refiling claims for contribution, presumably in a plenary proceeding, after the entry of judgment. No such claims had been filed when the district court entered judgment barring the filing of contribution claims.

to the defendant in a § 10(b) case are adequately counterbalanced by the requirement that the plaintiff establish scienter. See e.g. *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783, 786 (2d Cir. 1951). If the plaintiffs are correct in believing that a § 10(b) defendant is not entitled to contribution, then the basis for finding an implied remedy is undercut. To state the matter differently, if the plaintiffs by eschewing their § 11 remedy may deprive defendants in a registered offering securities case of the right to contribution, then something more than procedural safeguards has been lost. Although the contribution issue in a § 10(b) proceeding is important in its own right, we submit that its relevance to the implied remedy issue is of equal if not greater significance under the facts of the present case.

Texas Securities Act

Plaintiffs asserted a pendent claim under § 33 of the Texas Securities Act, Art. 581-33(A)(2), Tex. Rev. Civ. Stat. (Supp. 1963). That statute imposes liability on persons who fraudulently offer or sell a security.[7] In the present case, the district judge submitted to the jury a special interrogatory as to whether each of the defendants was a "seller" and received an affirmative response as to certain defendants, including this Respondent. The court of appeals reversed the judgment of the district court as to liability under the Texas Securities Act, holding with respect to this Respondent that since it patently did not instigate any sales transactions, it was not a seller for

[7] Since 1969 the Texas Securities Act has been amended to impose liability upon aiders and abettors and upon controlling persons as well as upon sellers. As a result, "seller" is no longer a term which defines the only class of persons liable for damages in private fraud actions. This feature of the lawsuit further attenuates the already limited precedential effect of the state law holding of the court below.

purposes of the Texas Securities Act. (Defendant's Petition, App. A-29)

Plaintiffs contend that the court below ignored the controlling opinion of the Texas Supreme Court in *Brown* v. *Cole,* 155 Tex. 624, 291 S.W.2d 704 (Tex. 1956), and relied instead upon a contrary holding of a Texas Court of Civil Appeals in *Stone* v. *Enstam,* 541 S.W.2d 473 (Tex. Civ. App. 1976) (no writ). The Attorney General of Texas has filed an *amicus curiae* brief in this Court taking the same position.

Despite the convoluted exegesis of the provisions of the Texas Securities Act in the Cross Petition and in the *amicus* brief, the question for consideration in determining whether to grant a writ on this state law issue is exceedingly simple: Did the court in *Enstam* overrule the Texas Supreme Court holding in *Brown* v. *Cole* or did it construe the holding in that case? To ask the question is to answer it. In *Brown* v. *Cole,* the court defined the class of persons subject to liability, metaphorically, by holding that "the seller may be any link in the chain of the selling process or in the words of the Act, he is one who performs 'any act by which a sale is made.' " The court in *Enstam* merely construed the *Brown* metaphor to mean that in order to be a "seller" a person must have participated in selling, 541 S.W.2d at 480.

Accordingly, despite the attempt by plaintiffs to couch their argument in terms consistent with Supreme Court Rule 17.1(a), the truth is that this Court is being petitioned to do nothing more than review the Fifth Circuit's construction of the Texas Securities Act. We submit that this is not an appropriate question for this Court.

CONCLUSION

The principal reason advanced by this Respondent for the granting of certiorari to consider the availability of a § 10(b) remedy for registered offerings is that, although

§ 11 of the Securities Act of 1933 affords a remedy which is sure and simple of application, claims under § 10(b) are subject to the vagaries which seem always to attend remedies developed through the judicial process. There could be no clearer confirmation of Respondent's position than the Cross Petition, which raises four § 10(b) questions and omits to raise at least two others of equal or greater significance. We submit, therefore, that the Cross Petition presents a better argument for the consideration of the underlying implied remedy issue than it does for the consideration of any of the four § 10(b) issues addressed in the Cross Petition. For the reasons stated earlier in this response, we believe that the only question presented in the Cross Petition which may be worthy of consideration is the standard of evidence issue, and as to that issue we would suggest that the Court may prefer to await further development by the lower courts.

Respectfully submitted,

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Opposition

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NO. 81-1076

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1981

RALPH E. HUDDLESTON, et al.,

Petitioners,

v.

HERMAN & MacLEAN, et al.,

Respondents.

RESPONDENT LESLIE SHARE'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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INTRODUCTION

Respondent Leslie Share (Share) respectfully requests this court to deny the petition for writ of certiorari in Case No. 81-1076, seeking review of an opinion of the Fifth Circuit reported at 640 F.2d 534. In requesting this court to deny the petition, Share relies and incorporates by reference the petition for certiorari filed by Herman & McLean, certified public accountants, in Case No. 81-680 -- which also seeks to review the Fifth Circuit's opinion -- and Share also relies on and incorporates by reference Herman & McLean's brief in opposition in this case.

The petition of Herman & McLean in Case No. 81-680 fairly identifies the parties, describes the opinions below, states the jurisdiction of this court, identifies the statutes and regulations involved and states the nature of this case. Share will not, therefore, repeat what has been done elsewhere. However, because the petition in this case does not fairly summarize the opinion below, Share offers his own brief summary of the decision. This summary, Share submits, further evidences why the petition in this case should not be granted and why the petition in Case No. 81-860 should be granted.

THE COURT OF APPEALS' OPINION

In its opinion, the Court of Appeals characterizes this case as one which "traverses the gamut of Rule 10b-5 issues." [640 F.2d at 538]

Faced with this gamut, the Court of Appeals determined that:

(1) plaintiffs had an implied remedy under § 10(b) of the Securities Exchange Act of 1934 (the 1934 Act), 15 U.S.C. § 78j(b), even though they had an express remedies under Sections 11 and 12 of the Securities Act of 1933, 15 U.S.C. §§ 77(k) and 77(l);

(2) the district court's judgment had to be reversed because issues concerning reliance and causation had not been submitted to the jury;

(3) defendants were not sellers of securities within the meaning of the Texas Securities Act;

(4) the district court had erroneously admitted evidence prejudicial to defendants;

(5) the district court had applied an improper recissionary measure of damages; and

(6) the district court had denied defendants' right to seek contribution from co-defendants who had settled with plaintiffs.

Because of the need for a new trial, the Court of Appeals did not discuss other errors challenged by defendants. [640 F.2d at 550, 553]

Although it recognized that this court had expressly reserved the question whether an implied cause of action under Section 10(b) of the 1934 Act is available when Congress has

created an express cause of action [640 F.2d at 541], the Court of Appeals nonetheless found an implied right of action because it was "an established remedy" whose continued existence was justified by reasons of sound policy. [640 F.2d at 542-543]

The Court of Appeals then stated the elements of this established remedy and proceeded to explain each element. It addressed particularly the issues of reliance and causation which the district court had refused to submit to the jury. It found that "[t]he district court, induced by counsel, confused materiality with reliance. . ." [640 F.2d at 548] and then "compounded its failure to submit the reliance issue to the jury by failing also to submit the question of causation." [640 F.2d at 549] As a result the district court's judgment had to be reversed. The Court of Appeals explained that both reliance and causation are issues in every 10b-5 case and that:

> Establishing reliance, however, merely proves that the plaintiff was induced to act by the defendant's conduct. It is a nonsequitur to conclude that the representation that induced action necessarily caused the consequences of that action. . . . Rule 10b-5 requires proof both that the plaintiff relied on the misstatement and that the misstatement was the cause of his loss. [640 F.2d at 547]

The causation requirement is necessary so that Rule 10b-5 does not become "an insurance plan for the cost of every security purchased in reliance on a material misstatement or omission." [640 F.2d at 549]

Based on decisions of the Texas courts, the legislative history of the Texas statute and analogy to the federal statute on which the Texas statute was based, the Court of Appeals also found that defendants were not "sellers" within the meaning of the Texas Securities Act. [640 F.2d at 550-551 and Note 27]

REASONS FOR DENYING THE WRIT

1. This petition and the petition No. 81-860 arise out of the same case. The petition in No. 81-860 presents the question whether a private right of action can be implied under Section 10(b) of the 1934 Act for purchasers of securities to whom Congress granted express remedies under Sections 11 and 12 of the Securities Act of 1934. If this court decides that an implied remedy does exist, Share acknowledges that many of the questions raised by petitioners have not been clearly or consistently answered by the lower courts, at least in part because of this Court's somewhat piecemeal prior efforts to make sense of Rule 10b-5. But those unanswered questions do not justify issuing a writ of certiorari.

2. Petitioners correctly state that "[b]ecause private actions under Rule 10b-5 have been created judically, it has fallen to the courts to determine the elements of Rule 10b-5 suits." [Petitioners' Brief, p 11] This case is a perfect example of the burdens imposed upon the lower courts -- and this court -- by the effort to create an implied cause of action to "supplement" or "contradict" the express remedies created by Congress when it enacted the securities laws -- even though there is no need for such judicially-created remedies since they do no more

than "federalize" existing common law causes of action.

Even though this case was tried in 1979, the district court lacked any clear guidelines on the fundamental legal issues necessary to frame intelligent and workable jury instructions in a 10b-5 case. As a result, in a manner reminiscent of a medieval scholastic philosopher trying to determine how many angels could sit on the head of a pin, the arguments in both the trial court and the court of appeals involved sophisticated or sophistic efforts to plumb the depths of this court's sometimes cryptic comments in cases such as Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), and Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

What precisely this exercise accomplished in this case, and in numerous other cases decided by the federal courts -- at tremendous expense to already congested federal dockets -- is hardly clear. Certainly, however, to the extent that this court is being asked -- at this late date -- merely to recreate the common law of fraud, the exercise seems a monumental waste of time and judicial resources. Yet, when all is said and done, that is precisely what petitioners want this court to do: to imply additional remedies which Congress chose not to enact in an effort to create a "federal" common law of securities fraud.

Because there is no justification for such a creative effort, this court should cut the Gordian knot and state, once and for all, that the remedies available under federal securities laws are those expressly created by Congress.

and that judicial efforts to expand upon Congress' legislation will not be permitted.

3. Assuming, arguendo, that this court concludes that the judicially-created private remedy under Rule 10b-5 deserves to exist, Share suggests that the questions raised by petitioners will not dispose of this case and, therefore, the petition should not be granted to decide only some of the "gamut" of issues which the court of appeals recognized must be addressed on retrial without knowing what proofs will be admitted into evidence on retrial. [See 640 F.2d at 550, 553]. For example, petitioners challenge the court of appeals' reasoning on "reliance," but they do not challenge the reasoning on "causation" -- a question which also was not submitted to the jury; nor do they challenge the other errors which also mandated a reversal of the district court's judgment.

4. Finally, there is no reason for this court to address the state law questions raised by the petition. The petition tries to transform state law questions into federal questions by misstating the record. The court of appeals did not disregard controlling decisions of the Texas Supreme Court; rather it attempted to construe the language of the Texas Securities Act consistent with decisions of the Texas state courts which had not directly addressed the precise question before the court of appeals. Therefore, if the court of appeals erred, it did so only by its construction of a statute and not by its method of procedure. Moreover, in 1977 the Texas statute in issue was substantially amended to cure the very state law questions posed by this case [see 640 F.2d at 551 n. 27]; and, therefore, a decision of this court would have no jurisprudential significance.

CONCLUSION

This court should deny the writ of certiorari in Case No. 81-1076 and grant the petition in Case No. 81-680 to decide that there is no implied right of action under Section 10(b) for purchasers of securities who have express remedies under Sections 11 and 12 of the Securities Act of 1933.

Respectfully submitted,

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SW14d

Petitioner's Reply Brief

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No. 81-1076

IN THE

Supreme Court of the United States

October Term, 1981

RALPH E. HUDDLESTON and
CHESTER E. BRADLEY, Jr.,
individually and as designated Class Representatives *et al.*,
Petitioners,

v.

HERMAN & MACLEAN, LAWRENCE A. LOPATIN,
and LESLIE SHARE,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITIONERS' REPLY BRIEF

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PARTIES

Petitioners – appellees in the Court below – are Ralph E. Huddleston, Chester E. Bradley, individually and as class representatives, the class they represent, and David E. Kemp, Thomas F. Plant, Felton F. Waggoner, Jack H. Barrett, and Daryl Lostax. Respondents – appellants in the Court below – are Herman & MacLean, certified public accountants, Lawrence A. Lopatin, and Leslie Share.

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PETITIONERS' REPLY BRIEF

ARGUMENT

Petitioners Huddleston and Bradley, *et al.*,[1] dispute much of what Respondent Herman & MacLean[2] asserts in its Brief in Response to Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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[1]Although both Huddleston and Bradley, *et al.*, and Herman & MacLean have filed petitions for a writ of certiorari, for convenience we refer to Huddleston and Bradley, *et al.*, as "Petitioners," and Herman & MacLean as "Respondent."

[2]*See* note 1, *supra.*

("Response"), filed at the request of this Court. In this Reply, however, Petitioners will respond only to the quasi-jurisdictional or ripeness contentions which suggest that review is inappropriate at this juncture of the case.

Herman & MacLean contends generally that because a new trial is required by the Court of Appeals decision, this Court should postpone review because the issues presented "may vary in contextual significance as a result of a new trial and a new appeal. . . ." Response at 4. As Respondent concedes, however, this Court has jurisdiction under 28 U.S.C. § 1254(1) over any case in the courts of appeals "before or after rendition of judgment." In this case, the Court below has rendered a final judgment accompanied by a complete opinion. Moreover, judicial resources would be conserved by review now rather than following a new trial and a new appeal. Any retrial will necessarily require the trial court to act upon four of the five questions presented by Petitioners; only one question could even theoretically become moot after retrial.[3] Most important, a new trial will not serve to focus better the issues presented by Petitioners. The issues raised by Petitioners are clear legal questions; the lengthy opinion by the Court below has framed the issues; no fact relevant for adjudication is any longer in dispute;[4] and the conflicts among the

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[3]The proper standard of proof in Rule 10b-5 actions (question 1); the question of reliance in Rule 10b-5 actions (question 2); the plaintiff's obligation in Rule 10b-5 cases to prove due care (question 3); and the proper procedure for determining Texas securities law (question 5) would inevitably be presented in a new trial. Only the issue of contribution under Rule 10b-5 (question 4) could become moot if Respondents prevailed in a new trial.

[4]Although Respondent Herman & MacLean is still challenging the jury's finding of scienter and intentional fraud, Response at 6-7, that question was decisively put to rest by the Court of Appeals. *See* App. A-18-19, No. 81-680. Herman & MacLean abandoned that issue in its own petition to this Court for review. *Herman & MacLean v. Ralph E. Huddleston and Chester E. Bradley, Jr.*, No. 81-680.

Circuits cited in Petitioners' Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit ("Petition") prove the ripeness of these issues for review.[5] In short, nothing will be gained and much lost by postponing review.

Respondent claims that the Court should not resolve the market fraud issue presented by Petitioners in question 2, because there is nothing in the record to support the market fraud theory and because the Court of Appeals opinion does not address the issue. Response at 8 & nn.4, 5. Neither contention has merit. Contrary to Respondent's assertion, this Court does *not* normally decline to consider legal issues "not covered by a a lower court opinion." Response at 8 n.4, *citing NLRB v. Sears, Roebuck & Co.*, 421 U.S. 132 (1975); *Ramsey v. United Mine Workers*, 401 U.S. 302 (1971). Rather, what this Court does decline to do is review an issue when "[w]e are *unsure whether it was presented below* and whether, in any event, there is record support for it." *Ramsey v. United Mine Workers*, 401 U.S. at 313 (emphasis added). In this case neither defect is present.

Petitioners did argue the market f.aud theory in the Court below, as Respondent concedes. Response at 8 n.4. Indeed, the market fraud theory, in those terms, was even argued before the trial court. *See* excerpt from the transcript of Hearings on Motions, October 15, 1979, which is appended to this Brief. And, contrary to Respondent's assertion, Response at 8, the record in this case does support the market fraud theory. As the Court of Appeals

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[5]Respondent asserts that even if Petitioners prevail on each of the four Rule 10b-5 issues presented in its Petition, the "judgment of the Fifth Circuit would be unaffected." Response at 3. This assertion is patently wrong. If Petitioners prevail on any one or more of the Rule 10b-5 issues, the judgment of the Fifth Circuit in this case, like the judgments in all Rule 10b-5 cases, will be "affected."

decision recounts, the jury found, *inter alia,* that the TIS prospectus was "materially misleading" with respect to the "working capital position of TIS on October 30, 1969." App. A-4 n.2, No. 81-680. The false and materially misleading working capital position provided in the TIS prospectus certainly worked a fraud on the market. Had the underwriters known of TIS' correct financial situation, they would have withdrawn or substantially revised the offering.[6] *See* Petitioners' Petition at 14-15.

In its enthusiasm for arguing why review of this case ought to be postponed, Respondent has ignored the conflicts among the courts of appeals that hamper adjudications under Rule 10b-5: conflicts over the burden of proof, *see* Petitioners' Petition at 7 & n.3; conflicts over individual proof of reliance in cases involving half-truths and market fraud, *see id.* at 15, 18-19; conflicts over whether the plaintiff must prove his own due care, *see id.* at 21. Until those conflicts are resolved by this Court, no Rule 10b-5 case — let alone the one at bar on remand — will be properly decided in accordance with a single, uniform national standard.

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[6] As the State of Texas argues in relation to the Texas Securities Act, "[a] purchase in the secondary market either directly relies upon the prospectus *or relies upon the fact that the market value of the security reflects the value and financial condition of the corporation set out in the information contained in the prospectus.*" Amicus Brief on Behalf of the State of Texas at 10 (emphasis added). The theory underlying the emphasized language is that a materially misleading statement directly affects the market value of a security and therefore operates as a fraud on the market. *See* Petitioners' Petition at 12-16.

CONCLUSION

For the foregoing reasons, the Court should grant the writ of certiorari.

Respectfully submitted,

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APPENDIX

Excerpt from Transcript of Hearings
on Motions, October 15, 1979, at 80-81.

Mr. Jaffe: . . . These people in each case we say have looked to the information contained in the Registration Statement and Prospectus as a basis for buying. This is a *fraud on the market* theory discussed in *Rifkin v. Crow*, Your Honor, as being a possible basis and no need for reliance, Your Honor, because at the end of the discussion by the Fifth Circuit in *Rifkin v. Crow* it's also the same basis for the *Ross v. Robbins* case, the September 24, 1979 case of the Second Circuit which we have cited on that particular point. Once you have information in the market people would ordinarily rely on which is materially misleading on the basis of material omissions and fraudulent non-disclosures, until it's corrected there is a right to claim the action. (Emphasis added.)

Amicus Brief

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On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF ARTHUR ANDERSEN & CO., AMICUS CURIAE

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BRIEF OF ARTHUR ANDERSEN & CO., AMICUS CURIAE

Arthur Andersen & Co. ("Andersen") submits this brief as *amicus curiae* in support of respondent's position that in private Rule 10b-5 actions the plaintiff must prove all elements of his claim by clear and convincing evidence. The petition states as the "question presented for review":

> Is the clear and convincing standard the appropriate burden of proof in private Rule 10b-5 actions?

Interest of Amicus Curiae

Andersen is an international accounting firm and one of the so-called "Big Eight." In the related matter entitled *Herman & MacLean* v. *Huddleston*, No. 81-680, Andersen stated its interest in the issue whether Congress intended to imply private civil remedies under § 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder and § 17(a) of the Securities Act of 1933. Such statement also applies to Andersen's interest in the issue of "the appropriate burden of proof in private Rule 10b-5 actions."

Prior to *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), plaintiffs in Rule 10b-5 cases, aware of the difficulty of proving that an outside accounting firm knowingly engaged in fraud in auditing its client's financial statements, simply pleaded negligence, believing this sufficed. As *Hochfelder* noted, the plaintiffs there "proceeded on a theory of liability premised on negligence," *id.* at 215, which was then a common approach. Since *Hochfelder*, a Rule 10b-5 complaint now automatically alleges fraud and, as *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 740 (1975), observed, does so with the hope that despite "little chance of success at trial" such a complaint may nevertheless have substantial "settlement value." Since fraud is, at least in theory, the *sine qua non* of a Rule 10b-5 case, the standard of proof is particularly important.

Highly relevant is the effect of fraud on the reputation of professionals, such as independent accountants. Accordingly, it is important to accountants and other professionals, particularly in jury trials, that plaintiffs be required to prove their case by a standard of proof at least as high as clear and convincing evidence, rather than by the mere preponderance of the evidence.

Summary of Argument

The standard of proof in an action based on fraud, which this Court has called the "intermediate standard," employs a combination of the words "clear," "cogent," "unequivocal" and "convincing." This standard has been reaffirmed by this Court in a variety of civil cases involving fraud. It is also the uniform standard as to common law fraud in all or substantially all states.

A private civil action under Rule 10b-5 is a fraud action and should be governed by the same standard as all other fraud actions. Lower federal courts have generally applied the fraud standard in Rule 10b-5 cases, other than in "churning" cases, which do not require proof of intent to defraud.

Since Rule 10b-5 cases generally include a separate claim based on common law fraud, which would require the higher standard, applying the fraud standard of proof to Rule 10b-5 cases avoids different jury instructions on the same factual situation between the same parties.

ARGUMENT

POINT I

Rule 10b-5 is a fraud provision which requires the fraud standard of proof.

Hochfelder made clear that Rule 10b-5 requires "intent to deceive, manipulate, or defraud," 425 U.S. at 193. *Chiarella* v. *United States*, 445 U.S. 222, 235 (1980), stated that what § 10(b) "catches must be fraud."

The 1934 Act does not deal with the degree of proof required in private suits under § 10(b), since the litigation

thereunder is based entirely on a remedy created by the judiciary. Accordingly, as stated in *Woodby* v. *Immigration and Naturalization Service*, 385 U.S. 276, 284 (1966), "the question of what degree of proof is required" in civil actions based on fraud "is the kind of question which has traditionally been left to the judiciary to resolve . . . ."

Addington v. *Texas*, 441 U.S. 418, 423-24 (1979), specified the standards of proof for three distinct types of cases. "At one end of the spectrum is the typical civil case involving a monetary dispute between private parties," where "plaintiff's burden of proof is a mere preponderance of the evidence." At the other end is the criminal case which requires proof "beyond a reasonable doubt." Between them is "[t]he intermediate standard, which usually employs some combination of the words 'clear,' 'cogent,' 'unequivocal' and 'convincing.' " *Addington* discussed the "intermediate standard" as follows (*id.*):

> One typical use of the standard is in civil cases involving allegations of fraud or some other quasi-criminal wrongdoing by the defendant. The interests at stake in those cases are deemed to be more substantial than mere loss of money and some jurisdictions accordingly reduce the risk to the defendant of having his reputation tarnished erroneously by increasing the plaintiff's burden of proof.

This Court, the lower federal courts and substantially all state courts recognize that a charge of fraud in any civil case differs from other civil cases because of the consequences of fraud. Accordingly, this Court has consistently held that civil fraud cannot be established by mere preponderance of the evidence, but requires "clear, unequivocal and convincing evidence." Some of its leading decisions may be briefly recalled.

Maxwell Land-Grant Case, 121 U.S. 325, 381 (1887)—a suit to set aside an instrument for fraud—stated that "the

testimony on which this is done must be clear, unequivocal, and convincing, and that it cannot be done upon a bare preponderance of evidence . . . ."

Woodby, supra, 385 U.S. at 285 n.18, referred to the requirement that the allegations in denaturalization cases must be established "by clear, unequivocal, and convincing evidence," and stated that "*[t]his standard, or an even higher one, has traditionally been imposed in cases involving allegations of civil fraud . . .*" (citing 9 Wigmore, *Evidence,* § 2498 (3d ed. 1940)).*

Schneiderman v. *United States,* 320 U.S. 118, 120-21, 125 (1943), which arose under a statute authorizing cancellation of a certificate of citizenship for fraud, held that a civil fraud action "needs more than a bare preponderance of the evidence to prevail." The "evidence must be clear, unequivocal and convincing." *See also Baumgartner* v. *United States,* 322 U.S. 665, 671 (1944) (proof of civil fraud must be "clear, unequivocal and convincing"); *Nowak* v. *United States,* 356 U.S. 660, 663 (1958) (fraud requires proof by "clear, unequivocal and convincing evidence").

Lalone v. *United States,* 164 U.S. 255, 257-58 (1896)—a suit to recover moneys paid an applicant for a pension—held that the standard of "mere preponderance of evidence" is "not sufficient to warrant a finding of fraud, and will not sustain a judgment based on such finding"—a principle "exemplified in *United States* v. *Iron Silver Mining Co.,* 128 U.S. 673 [1888], and cases cited . . . ." That case held that "for fraud . . . the testimony . . . must be clear, unequivocal and convincing . . . ," 128 U.S. at 677. *Lalone* stated that this "*rule is of long standing and is of universal application,*" 164 U.S. at 257.

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* Unless otherwise noted, italics in quoted material have been supplied.

The lower federal courts, practically without exception, have also made clear that "fraud" requires a different standard of proof than in other civil actions, and that the standard is "clear, cogent and convincing evidence."

In *Collins Sec. Corp.* v. *SEC*, 562 F.2d 820, 824 (D.C. Cir. 1977), the court, in dealing with charges of fraud in an SEC administrative proceeding, stated that "*[t]here are literally hundreds of cases decided by the United States courts of appeals in which the standard applied in fraud situations has been 'clear and convincing evidence.'*"*

Barr Rubber Products Co. v. *Sun Rubber Co.*, 425 F.2d 1114, 1120 (2d Cir.), *cert. denied*, 400 U.S. 878 (1970)—reversing because of "the lower court's failure to define the quantum of proof"—stated:

> Generally, a civil plaintiff must prove his affirmative case by no more than a preponderance of the evidence. . . .
>
> However, there is ample authority of long standing that to substantiate charges of fraud . . . , at least in actions seeking the recovery of monies paid or the rescission or cancellation of contracts, a litigant must present "clear and convincing proof."

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* This case was overruled by *Steadman* v. *SEC*, 450 U.S. 91 (1981), on the narrow ground that the civil fraud issue had arisen in an administrative proceeding; that Congress intended the applicable standard to be the one under the Administrative Procedure Act; and that the standard is provided for in "the language of the statute itself." The "hundreds of cases" in the federal courts, to which the Court of Appeals referred, "in which the standard applied in fraud situations has been 'clear and convincing evidence'" are not administrative proceedings where the standard is determined by the APA and are therefore not affected by *Steadman*. Petitioner's petition, filed December 10, 1981, concedes that "*Steadman* is technically distinguishable from the present case" (p. 8).

In support, the Court cited a number of cases in various federal courts throughout the United States.*

All or substantially all state courts also apply the "clear and convincing" standard in fraud cases. *Addington, supra,* 441 U.S. at 424, cited "9 J. Wigmore, *Evidence* § 2498 (3d ed. 1940)" in support of the "intermediate standard," and *Wigmore* cites a large number of states which apply the higher standard, and as *contra,* decisions in only four states, Alabama, Arkansas, Michigan and North Carolina. However, such decisions have been superseded in these four states by subsequent decisions which apply the higher standard.**

It is the practice in English courts to require a substantially higher standard of proof for fraud charges in civil

* *Bowen* v. *B.F. Goodrich Co.,* 36 F.2d 306, 308 (6th Cir. 1929) ("must establish the fraud by evidence that is clear and convincing"); *Whitmarsh* v. *Pennsylvania Railroad Co.,* 61 F. Supp. 850, 852 (E.D. Pa. 1945) ("under the federal practice, . . . evidence [of fraud] must be clear, cogent, convincing and certain, or, as it is frequently stated, . . . 'clear, unequivocal, and convincing' proof"); *Lion Oil Refining Co.* v. *Albritton,* 21 F.2d 280, 282 (8th Cir. 1927) ("the proof [of fraud] must be clear, unequivocal, and convincing"); *Merwin* v. *New York, N.H. & H. R.R.,* 62 F.2d 803, 804 (2d Cir. 1933) (fraud can be established only "by clear, unequivocal, and convincing evidence"); *Merrill-Stevens Dry Dock Co.* v. *M/V "Laissez Faire",* 421 F.2d 430, 433 (5th Cir. 1970) ("fraud . . . must be proven by clear and convincing evidence"); *Mensik* v. *Commissioner,* 328 F.2d 147, 150 (7th Cir.), *cert. denied,* 379 U.S. 827 (1964) ("[c]ivil fraud need not be proved beyond a reasonable doubt, but it must be established by clear and convincing evidence"); *Borowicz* v. *Chicago Mastic Co.,* 367 F.2d 751, 760 (7th Cir. 1966) ("[f]raud . . . must be affirmatively established by clear and convincing proof of each and every essential element").

** *See, e.g., Taylor* v. *Godsey,* 357 So.2d 979, 981 (Ala. 1978) ("only by evidence that is clear and convincing"); *Davidson* v. *Bell,* 447 S.W.2d 338, 340 (Ark. 1969) (to set aside a deed for fraud, "the law requires that the proof be clear, cogent and convincing"); *Hi-Way Motor Co.* v. *Int'l Harvester Co.,* 398 Mich. 330, 247 N.W.2d 813, 816 (1976) ("[f]raud . . . must be proven by clear, satisfactory and convincing evidence"); *In re Palmer,* 296 N.C. 638, 252 S.E.2d 784, 789-90 (1979).

actions than "the balance of probability" normally applicable, though there is little case authority on the issue. This was explained in *Hornal* v. *Neuberger Products, Ltd.*, [1956] 3 All E.R. 970, 974, by Lord Justice Hodson, as follows:

> The comparative dearth of express authority on this topic is not surprising. No responsible counsel undertakes to prove a serious accusation without admitting that cogent evidence is required, and judges approach serious accusations in the same way. . . .

POINT II

A Rule 10b-5 case is simply a civil action for fraud. Accordingly, the fraud standard of proof applicable to all civil fraud actions also applies to Rule 10b-5 cases.

As already noted, this Court has held that a Rule 10b-5 case is a fraud action; "what it catches must be fraud," *Chiarella, supra,* 445 U.S. at 234-35. Hence, a civil action under Rule 10b-5 is a civil fraud action. And, to quote *Addington, supra,* 441 U.S. at 424, Rule 10b-5 cases also involve "quasi-criminal wrongdoing."

Petitioner would have this Court now carve out a special exception from the "intermediate standard," applicable to Rule 10b-5 private civil fraud actions. There is no suggestion, however, that "the risk to the defendant of having his reputation tarnished erroneously"—a concern expressed in *Addington, supra,* 441 U.S. at 424—by a charge of securities fraud is less than in all the other types of civil fraud cases, so as to require treating securities fraud cases exactly like "the typical civil case involving a monetary dispute between private parties."

There is no basis in logic, common sense or precedent for carving out such a unique and unwarranted exception to the "intermediate standard." Indeed, the courts have consistently recognized the special vulnerability of professionals, such as accountants, charged with securities fraud because "allegations of fraud made against accountants . . . can threaten their entire professional status. . . ." *Sloan* v. *Canadian Javelin, Ltd.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,579 at 96,033 (S.D.N.Y. 1974). *See Felton* v. *Walston & Co.*, 508 F.2d 577, 581 (2d Cir. 1974); *Gilman Bros., Inc.* v. *Peat, Marwick, Mitchell & Co.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,512 (S.D.N.Y. 1978).

In *Kass* v. *Hornblower & Weeks-Hemphill Noyes*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,721 at 96,383 (S.D.N.Y. 1974), the court stated:

> A strong argument can certainly be made that at least a private damage cause of action under Section 10(b) and Rule 10b-5 is close enough to a fraud cause of action, *see Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973), so that the stricter burden of proof should be applied. *The gravity of a finding of Section 10(b) and Rule 10b-5 violation, as to its effect on the business or professional standing of the defendant, would seem to be equally as serious as a finding of common law fraud.* Our court of appeals has commented on the seriousness of a fraud finding as necessitating proof by the more rigorous standard. *McDonnell* v. *American Leduc Petroleums, Ltd.*, 456 F.2d 1170, 1176 (2d Cir. 1972).

Petitioners' reliance on "churning" cases (pet. at 7, n.3), where the burden has been stated as "preponderance of the evidence," is misplaced. The reason for the lower standard, as explained in *Hecht* v. *Harris Upham & Co.*, 430 F.2d 1202, 1209 (9th Cir. 1970), is that in "an allegation

of churning . . . [p]*roof of a specific intent to defraud is unnecessary.*"

Dzenits v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 171 n.2 (10th Cir. 1974), states that "proof of churning does not require proof of a specific or invidious intent to defraud" and "carries a less stringent burden of proof—one measured by the 'preponderance of the evidence' standard." *Dzenits*, recognizing the distinction between churning and a fraud case, stated that "*a complainant alleging common law fraud has the burden of proving the fraud by clear, cogent and convincing evidence.*" *Id.*

Similarly, *Van Alen* v. *Dominick & Dominick, Inc.*, 441 F. Supp. 389, 403 (S.D.N.Y. 1976), *aff'd*, 560 F.2d 547 (2d Cir. 1977)—though applying the "preponderance of the evidence" standard to churning—stated that fraud had not been established because "under the applicable law, the evidence of fraud must be 'clear and convincing' and any inference of fraud 'unequivocal.'"

Petitioners also argue that in *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), "this court applied the preponderance standard to cases brought under section 17(a)" (pet. 6). However, *Joiner* did not hold that the "preponderance of the evidence" standard applied to the fraud. This Court merely said, 320 U.S. at 355, that this is the standard applicable to whether certain documents are securities, which could be proved by "the document itself" or by going "outside the instrument itself as we do here. Where *this proof* [meaning proof that the instrument is a security], is offered in a civil action, as here, a preponderance of the evidence will establish the case . . . ." This clearly relates only to proof of the nature of the document, and not to proof of the alleged fraud.

POINT III

Recognition of the need for different treatment of fraud in other aspects of federal securities litigation.

A. Pleading Requirements

Rule 8(a), Fed. R. Civ. P., requires that a civil complaint merely contain "a short and plain statement of the claim showing that the pleader is entitled to relief," except where fraud is alleged. "In all averments of fraud . . . the circumstances constituting fraud . . . shall be stated with particularity."* Rule 9(b).

The reason Rule 9(b) requires that "the circumstances constituting fraud" be "stated with particularity" is the same reason why the fraud standard of proof is "clear," "convincing," "unequivocal" and "cogent" evidence. Rule 9(b) also recognizes the seriousness of fraud charges, and the tarnish to reputation, particularly of professionals such as accountants.

It has never been suggested that Rule 9(b) is inapplicable to fraud charges in Rule 10b-5 cases. On the contrary, since the bulk of federal civil fraud litigation is in the securities field, substantially all cases applying Rule 9(b) are also in the securities field.

B. Statute of Limitations

Where Congress expressly provided a private civil action under the federal securities law, it also provided for the applicable statute of limitations. *See, e.g.*, § 13 of the

* New York state practice parallels the federal practice. The ordinary civil complaint consists of "plain and concise statements," CPLR 3014. But "where a cause of action . . . is based upon fraud . . . the circumstances constituting the wrong shall be stated in detail." CPLR 3016(b).

1933 Act and § 18(c) of the 1934 Act. But because Congress did not provide for private civil actions under § 10(b), there is no statute of limitations for a Rule 10b-5 action. Accordingly, a federal court, faced with fixing the statute of limitations in a Rule 10b-5 case and recognizing that the action is a civil fraud action, applies the fraud statute of limitations in effect in the state in which the court is sitting.

IIT v. *Cornfeld*, 619 F.2d 909, 928 (2d Cir. 1980), states:

> Federal law looks to analogous state law to supply the period of limitations for Rule 10b-5 actions . . . . This circuit has uniformly found the analogy in the limitations period which the state had provided for an action based upon common law fraud.

See also Roberts v. *Magnetic Metals Co.*, 611 F.2d 450, 454-55 (3d Cir. 1979), which cites a large number of decisions where "[t]he common law fraud statute of limitations was held applicable . . . ."

It will be difficult to suggest a reason why, if a civil action under Rule 10b-5 is one in fraud for purposes of Rule 9(b) and the fraud statute of limitations, it is not also a fraud action for purposes of the standard of proof.

POINT IV

It is standard practice for plaintiffs in Rule 10b-5 private civil actions to include a separate common law fraud claim and demand a jury trial. Avoidance of two separate standards of proof will reduce jury confusion.

Substantially all Rule 10b-5 complaints follow the same pattern, particularly where there is doubt whether the federal claim can stick. The standard practice is to sue accountants under Rule 10b-5 and § 17(a); allege both pri-

mary fraud and aiding and abetting liability; and restate all the allegations as part of a common law fraud count, based on pendent jurisdiction.* Then, if the federal securities fraud claim is dismissed, the Court may be persuaded to retain the common law fraud claim under pendent jurisdiction and in the interest of judicial economy. *Ryan v. J. Walter Thompson Co.*, 453 F.2d 444, 445 (2d Cir. 1971), *cert. denied*, 406 U.S. 907 (1972), decried this practice of "engrafting upon the misplaced federal securities law claim a state law claim that, but for the federal gloss, should have been litigated in the state courts."

Also, plaintiffs in Rule 10b-5 cases against accountants invariably demand a jury trial, especially for a long and complicated case. *Addington, supra*, 441 U.S. at 424, suggested uncertainty as to "what lay jurors understand concerning the differences among these three tests or the nuances of a judge's instructions on the law . . . ." It had "found no study comparing all three standards of proof to determine how juries, real or mock, apply them." *Id.* at 424 n.3.

As to a common law fraud claim, based on pendent jurisdiction, the federal court must apply the "clear and convincing evidence standard," which *Addington* states is the "typical . . . standard . . . in civil cases involving allega-

* This use of Rule 10b-5, as well as "pendent claims for common law fraud," to assert what appears to be a state law action, arose at the oral argument in *Marine Bank v. Weaver*, —— U.S. ——, 102 S.Ct. 1220, 1222 (1982), as appears in Sec. Reg. L. Rep. (BNA) 60 (Jan. 13, 1982):

> Justice O'Connor asked what the practical advantages were in this case in filing suit in federal court rather than in a state forum. Conner replied that while the antifraud provisions of the federal securities laws include liability for omissions of material facts, there may not be a cause of action under state law for such omissions. The guarantors of the loan charged that the bank had failed to tell them that the meat packing company was insolvent.

tions of fraud," *id.* at 424, and which is unequivocally required by state law. However, if the federal court then applies the "preponderance of the evidence" standard to the fraud claim, because asserted under Rule 10b-5, the jury will be instructed to apply two separate standards to the same claim by the same plaintiff against the same defendant, involving the same evidence and seeking the same damages. If the same standard of "clear and convincing" proof is applied to the fraud claim, under Rule 10b-5, as is applied to the fraud claim under state law, jury confusion should be reduced.*

---

* Some courts feel that cases presenting "unique and difficult accounting concepts" are too complex for a jury, which "would not be a rational and capable fact finder." *In re Boise Cascade Securities Litigation*, 420 F. Supp. 99, 102-03 (W.D. Wash. 1976). *See also Hyde Properties* v. *McCoy*, 507 F.2d 301 (6th Cir. 1974); *Rosen* v. *Dick*, 83 F.R.D. 540, 544 (S.D.N.Y. 1979), *modified*, 639 F.2d 82 (2d Cir. 1980) ("complex issues of accounting practice [are] beyond the normal comprehension of the jury"); *Bernstein* v. *Universal Pictures, Inc.*, 79 F.R.D. 59 (S.D.N.Y. 1978).

Conclusion

The petition requests this Court to enunciate a uniform standard of proof in Rule 10b-5 cases (pet. 10), which obviously is desirable. However, the "uniform standard" should be the one which this Court has uniformly applied in all fraud cases, namely, evidence which is "clear and convincing," as well as "cogent" and "unequivocal."

Dated: June 18, 1982

Respectfully submitted,

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IN THE
SUPREME COURT OF THE UNITED STATES
October Term, 1981

RALPH E. HUDDLESTON AND
CHESTER E. BRADLEY, JR.,
INDIVIDUALLY AND AS DESIGNATED
CLASS REPRESENTATIVES, ET AL.,
Petitioners,

v.

HERMAN AND MACLEAN, LAWRENCE A.
LOPATIN AND LESLIE SHARE,
Respondents.

AMICUS CURIAE BRIEF ON BEHALF OF THE STATE OF TEXAS ACTING THROUGH RICHARD D. LATHAM, SECURITIES COMMISSIONER OF TEXAS, IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTION PRESENTED FOR REVIEW

Can a federal appellate court construe a state securities statute contrary to the interpretation of that state's highest court?

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IN THE
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Pursuant to the Rules of the Supreme Court of the United States, the State of Texas, acting through Richard D. Latham, Securities Commissioner of the State of Texas, represented herein by Mark White, Attorney General of Texas, files this its brief as amicus curiae.

INTEREST OF AMICUS CURIAE

The Court in its order of March 9, 1981, in the above-numbered and entitled lawsuit, held that Lawrence LoPatin, Leslie Share and Herman and MacLean, Inc. (hereinafter "defendants"), the corporate officers and accountants who prepared the prospectus of Texas International Speedways, Inc., in connection with a

securities offering, are not sellers of those securities under the Texas Securities Act. The State of Texas, through its Securities Commissioner, Richard D. Latham, respectfully requests that this Court grant the writ of certiorari to hear this question on the grounds that the restrictive interpretation of the Texas Securities Act set forth in the opinion of the Court below will seriously impair the enforcement of the securities laws of the State of Texas.

Although Section 33 of the Act, the civil liabilities provision, was amended in 1977 to cover individuals such as defendants and render them liable as "control persons or aiders" for misrepresentations, omissions or other forms of fraud in the sale of securities of a corporation which they controlled, the question before the court still has relevance to the enforcement of the penal and injunctive remedies under the Texas Securities Act, sections 29 and 32 respectively. The general definition of a "seller" under the Act is applied to all three provisions. A limited definition of a "seller", such as set forth in the opinion of the lower court, would seriously restrict the number of individuals who could be prosecuted or enjoined from violations of the Act. Frequently, the individuals behind the perpetration of a securities fraud are not the persons who conduct the actual sale of the security. It is for this reason that the Texas Supreme Court has given a broad interpretation to the definition of a "seller" under the Texas Securities Act so as to bring within the bounds of the Act the extremely wide and diffuse manner in which securities are sold. The interpretation of a "seller" under the Texas Securities Act set forth by the Fifth Circuit Court of Appeals would seriously hamper the enforcement of Texas securities laws.

REASONS FOR GRANTING THE WRIT

I. The Court below erred in holding that Respondents-Defendants were not "sellers" under the 1963

amendments to Section 33 of the Texas Securities Act.

A. *The Texas Supreme Court in Brown v. Cole stated the applicable test for determining a "seller" under the 1963 amendment to section 33 of the Texas Securities Act.*

The securities transactions complained of in plaintiffs' petition occurred while the 1963 amendments to the Texas Securities Act were in effect. The legislative history of Section 33 prepared by the Section of Corporation, Banking and Business Law of the State Bar of Texas stated the authoritative standard for determining which individuals would be liable as a seller under the Act:

> *Legislative History.* As originally submitted by the State Bar Committee on Securities and Investment Banking, new section 33 was substantially similar to the Uniform Securities Act sec. 410. However, it omitted the subsection of "Persons Liable" (on which *Brown v. Cole*, 155 Tex. 625, 291 S.W.2d 704, 59 A.L.R.2d 1011 (1956) will continue to be authoritative) and the provision for recovery of attorneys' fees by successful plaintiffs.

As set forth in the Comments, the intent of the legislature was to continue to use the *Brown v. Cole* rule regarding the scope of the definition of a seller who would be liable under Section 33, notwithstanding the changes that had been made in the section by the 1963 amendments. This officially reported, expressly stated legislative intent is the controlling explanation and interpretation of the statute regarding the spectrum of individuals who will be regarded as "sellers" under Section 33 of the Act.

B. *Defendants-Respondents are "sellers" under the Brown v. Cole rule.*

The Texas Supreme Court in *Brown v. Cole*, 291 S.W.2d 704 (Tex. 1956) looked to the broad definition of "sale" in Section 4 of the Act to define the Act's scope of a "seller" who would be liable under the Act's civil liabilities section for either failure to register or misrepresentation and fraud in the sale of securities. As a result, the court formulated the following rule:

> "As we interpret the Act, the seller may be any link in the chain of the selling process or in the words of the Act, he is one who performs 'any act by which a sale is made'."

This rule has been given a very broad interpretation by the Texas courts. In one example out of many, the court in *Christie v. Brewer,* 374 S.W.2d 908 (Tex.Civ.App.--Austin 1964, writ ref'd n.r.e.), found that a corporate executive officer was a seller of the corporation's securities even when the only act taken by her was confirming a sale to the purchaser appellee. The court reasoned that the confirmation was a link in the selling process and that it was immaterial that the officer did not herself solicit the sale, since she participated in a sale that had been solicited. The defendants would clearly come within the breadth of this rule. As the preparers and signers of the prospectus, they were a major link in the selling process, even though they did not directly solicit the sale, since the prospectus is the most important vehicle for the transmission of information about the corporation to prospective buyers of the securities.

C. *The Court below erred in holding that an intermediate appellate court decision, Stone v. Enstam, limited the scope of the rule set*

forth by the Texas Supreme Court in Brown v. Cole.

The only case relied upon by the court below which found that an individual who was a link in the selling process of a securities transaction was not a "seller" under the Act is *Stone v. Enstam*, 541 S.W.2d 473 (Tex.Civ.App.--Dallas 1976, no writ). *Stone v. Enstam* is a decision of an intermediate appellate court, the Texas Court of Civil Appeals, Fifth District, Dallas, Texas. The case was never appealed to the Texas Supreme Court which is indicated by the "no writ" nomenclature. Although there are a variety of ways the Texas Supreme Court can review a lower appellate court decision, the failure to appeal the case constitutes a waiver of these various ways of review. It is a matter of black letter law that a court of appeals' opinion which has not been reviewed by the Texas Supreme Court has only persuasive value and is not binding on any other court of civil appeals. The few opinions where the court has needed to state such an obvious rule of law are, ironically, those which have no writ history themselves. *Calvary Temple v. Taylor*, 288 S.W.2d 868 (Tex.Civ.App.--Galveston 1956, no writ); *Malone v. United States Fidelity and Guaranty Co.*, 9 S.W.2d 461, 463 (Tex.Civ.App.--Amarillo 1928, no writ). An unreviewed court of civil appeals opinion does not have the authority to modify or overrule a rule of law formulated by the Texas Supreme Court.

Moreover, the court in *Stone* attempted to contract the scope of the holding in *Brown* by limiting the *Brown* rule to the facts of the *Brown* case and thus, defining a "seller" as an active negotiator for the sale of securities. This restrictive view of the *Brown* rule has not been endorsed by any other Court of Civil Appeals whose decision has been reviewed by the Texas Supreme Court. In fact, decisions of Texas courts of civil appeals subsequent to the *Stone v. Enstam* decision continued to

quote the broad language of *Brown v. Cole. Enntex Oil & Gas Company (of Nevada) et al. v. State of Texas,* 560 S.W.2d 494, 497 (Tex.Civ.App.--Texarkana 1977, writ ref'd n.r.e.). Therefore, the *Stone* case must be viewed as being in conflict with the other Texas decisions interpreting the *Brown* rule and should not be followed by this Court.

Finally, the reasoning behind the *Stone* case would not be applicable to the facts of the case at bar. The court in *Stone* found that its facts differed significantly from *Brown,* since the defendant in *Stone* did not act as an agent on behalf of any party to the transaction and gratuitously volunteered to find a seller for the purchaser. The court apparently felt that it was the lack of a partisan relationship with the seller regarding the terms of the sale which rendered the defendant nonliable as a disinterested party to the sale. This was similar to the situation in *Herren v. Hollingsworth,* 167 S.W.2d 735 (Tex. 1943), where the defendant was considered to be merely a finder of a potential oil driller/oil lease purchaser and not a part of the interaction between the seller and purchaser in determining the price or other terms of the oil lease. However, in the case at bar, the corporate officers who would benefit, directly or indirectly, from the sale of the securities were involved in the preparation of the prospectus for the sale of the securities. They were not gratuitously offering their help to the corporation and their efforts were intimately a part of the terms and conditions of the sale of the securities to the general public. Although the courts have not been required to reach the outer parameters of the *Brown* rule, a president and vice-president who prepare and sign a prospectus would certainly be within the limits of the rule as the authors of the most important document for the transmission of information about the securities offering. The preparation of the prospectus is one of the most critical "links" in the process of the sale, since it is the document by which in-

vestors obtain information about a first time offering of the securities they are purchasing.

II. The court below erred in holding that the 1963 amendments to Section 33 of the Texas Securities Act excluded defendants from liability as "sellers" under the Act.

A. *The 1963 amendments did not limit the scope of the Brown rule.*

The Comments to the 1963 Amendments of Section 33 of the Texas Securities Act specifically state that the "Persons Liable" subsection of Section 410 of the Uniform Securities Act was omitted from the Amendments and, thus, the *Brown v. Cole* rule would be authoritative as to the persons liable under the Act. This legislative history clearly indicates that *Brown v. Cole* was to continue in force, notwithstanding any changes that had been made in Section 33 by the amendments.

Even Professor Bromberg, the strongest critic of the *Brown* rule and the author of the Comments to the 1977 amendments, stated in retrospect:

> "Old §33A allowed recovery only from 'any person who sells'. *Although the phrase would presumably be broadly construed,* see Brown v. Cole, 155 Tex. 625, 291 S.W.2d 704 [9 A.L.R.2d 101] (1956), its scope was unclear, particularly since the 1963 language could be read as narrower than the prior language interpreted in Brown v. Cole." Comments, 1977 Amendments, art. 581-33, TEX.REV.CIV.STAT. ANN. (Supp. 1980-81). (Emphasis added).

This court should follow other Texas courts and the presumption stated in Professor Bromberg's comments

to give Section 33 a broad construction under the *Brown v. Cole* rule which would encompass defendants as sellers.

B. *Even if the 1963 amendments "narrowed" Section 33, the defendants would still be liable under the Brown rule to purchasers in the primary or secondary markets.*

The 1963 amendments to section 33A(1) provide, in pertinent part:

> A. any person who
>
> * * *
>
> (2) offers or sells a security (whether or not the security or transaction is exempt under section 5 or 6 of this Act) by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements not misleading (when the person buying the security does not know of the untruth or omission, and who in the exercise of reasonable care could not have known of the untruth or omission) is liable to the person buying the security from him, who may sue either at law or in equity. . . .

Professor Bromberg has argued in an informal article which was not included in the legislative history that the 1963 amendments could be read as "narrowing" the language of Section 33 by the inclusion of a "privity" provision which provided that a seller is liable to the person buying the security from him. Bromberg, *Civil Liabilities under Texas Securities Act, §33 (1977) and Related Claims*, 32 Sw. L.J. 867, 901 n. 109 (1978). However, the legislative history of the 1963 amendments also states that *Brown v. Cole* is the authoritative

definition of a seller under §33. Even if Bromberg's "narrow" interpretation of §33 were to be accepted, the privity provision and the *Brown* rule must be read together.

The "broad" rule of *Brown v. Cole* can be harmonized with the "narrow" interpretation of the 1963 amendments by the interpretation that §33 was not given a "strict" privity provision. Thus, even though the purchaser and seller must be related to the same sale, the "seller" under §33 can be anyone who was a link in the selling process or who performed an act by which the particular sale to the plaintiff-purchaser was made. Under this interpretation of the 1963 amendments, although a purchaser could not sue a "seller" of the securities further up the chain of sale who was not related to the particular sale of the security to him, as he could have done under the 1941-1963 statute, he was not precluded from suing anyone who had performed any act by which the sale of securities was made to him, even if that person were not in strict privity.

The preparation of and the information contained in, the prospectus would be a link in the selling process of each sale of a security whether in the primary or secondary market, since it is a document addressed to, and is for the benefit of, the general public to enable the public to evaluate the value of the securities sold. A purchaser in the primary market directly relies upon the prospectus as to the financial condition of the corporation. In the case at bar, the corporation was required under §9 of the Texas Securities Act to offer its securities during the original offering to all purchasers by prospectus. In addition, the class certified by the trial court included all persons who purchased securities within 90 days of the original offering. Under federal securities law, all such purchasers must be given a copy of the prospectus prior to or at the time of the sale. 15 U.S.C. §§77(d)(3), 77(e)(b)(2). Therefore, the prospectus was a crucial link

in the selling process in the primary market to the plaintiff class at bar.

A purchaser in the secondary market either directly relies upon the prospectus or relies upon the fact that the market value of the security reflects the value and financial condition of the corporation set out in the information contained in the prospectus. Thus, all persons who prepare and sign the prospectus are performing an act by which a sale in the secondary market is made.

Therefore, the narrow view of the 1963 amendments, when read together with *Brown v. Cole,* would still require the holding that the corporate officers who prepared, signed, and misrepresented the company's financial condition in the prospectus are "sellers" under the Act and liable to the plaintiffs. To interpret the Act otherwise would reach the anomalous and unjust result that under Texas law a dealer or salesman who has no knowledge as to the accuracy of the prospectus would be liable for the misrepresentations in the prospectus while individuals who prepared the prospectus would not be so liable. The Texas Legislature did not intend such a result.

III. The Court below erred in using federal law to interpret the 1963 amendments to §33 of the Texas Securities Act.

In the Comments to the 1963 Amendments to §33 of the Texas Securities Act, the legislative history explicitly states that although §33 was generally modeled after Section 410 of the Uniform Securities Act, significant differences existed in the Texas Act which was finally enacted. Specifically, the "Persons Liable" section was omitted and *Brown v. Cole* was stated to remain the authoritative statement of who was a seller under §33. Therefore, §12 of the U.S. Securities Act, 15 U.S.C. §77*l*, derived from §410 of the Uniform Securities Act, would

not be analogous to §33. Further federal cases interpreting §12 of the U.S. Securities Act would not be appropriate guides for the interpretation of the 1963 amendments to §33 of the Texas Act. Due to the difference in the statutes, Texas law should be controlling as to the interpretation of the Texas statute.

CONCLUSION

For the reasons set out above, the State of Texas files this amicus curiae and prays that this Court grant the Petitioner's Writ of Certiorari.

Respectfully submitted,

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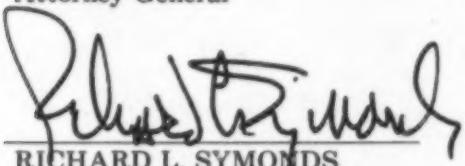

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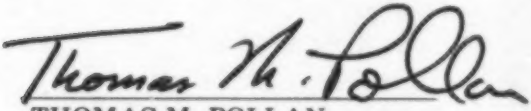

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Docket Sheet

NO. 81-1076-CFX (Vide: 81-680)	TITLE Ralph E. HUDDLESTON, et al., Petitioners v. Herman & MacLean, et al.

DOCKETED	COURT
Dec. 10, 1981	United States Court of Appeals for the Fifth Circuit

DATE	PROCEEDINGS AND ORDERS
	Counsel for Petitioners: Myer Feldman
	Counsel for Respondents: James L. Truitt,
Sept. 25, 1981	Application for an extension of time to file petition for writ of certiorari and order granting same until Dec. 10, 1981 by Powell, J, September 28, 1981.
Dec. 10, 1981	Petition for writ of certiorari filed.
Dec. 10, 1981	Appendix filed.
Jan. 11, 1982	Brief, amicus curaie, on behalf of The State of Texas Acting Through Richard D. Latham, etc. filed.
Jan. 13, 1982	DISTRIBUTED. 2-19.
Feb. 4, 1982	Response requested.
Mar. 1, 1982	Brief for respondents Herman and MacLean in opposition filed
March 8, 1982	Brief for respondent Leslie Share in opposition filed.
March 8, 1982	Reply brief for the petitioners filed.
March 10, 1982	DISTRIBUTED. 3-26.
March 30, 1982	REDISTRIBUTED. 4-2.
Apr. 5, 1981	The petition for writ of certiorari in No. 81-680 is GRANTED. The petition for writ of certiorari in No. 81-1076 is GRANTED limited to Question 1 presented by the petition. The case is consolidated with 81-680 and a total of one hour is allotted for oral argument.

Apr. 14, 1982	Order extending time to file the joint appendix and opening brief on the merits of Herman & MacLean until June 19, 1982. (Brief of Huddleston, et al. will be due July 19, 1982).
Apr. 23, 1982	Motion of Ralph E. Huddleston, et al. in No. 81-1076 for leave to enlarge question presented for review filed.
Apr. 27, 1982	DISTRIBUTED. 4-30. (Above motion).
May 3, 1982	The motion of Ralph E. Huddleston, et al., for leave to enlarge question presented for review is DENIED.
June 18, 1982	Brief for respondent filed. (Vide: 81-680, petitioner in vide case).
June 18, 1982	Joint appendix filed. (Vide: 81-680).
June 18, 1982	Brief, amicus curiae, of Peat, Marwick, Mitchell & Co. filed. (Vide: 81-680).
June 19, 1982	Brief, amicus curiae, of Securities Industry Association filed. (Vide: 81-680).
	(Over)

81-1076

Title

No.

DATE	PROCEEDINGS AND ORDERS
June 21, 1982	Brief, amicus curiae, of Arthur Andersen & Co. filed.
July 16, 1982	Brief for the Securities and Exchange Commission as amicus curiae filed. (Vide: 81-680).
July 19, 1982	Brief of Ralph E. Huddleston and Chester E. Bradley, Jr., et al. filed. (Vide: 81-680). (PETITIONERS)
July 16, 1982	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
Sept. 3, 1982	CIRCULATED.
Sept. 9, 1982	The motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument is GRANTED.
Sept. 20, 1982	Motion of Arthur Andersen & Co. for leave to participate in oral argument as amicus curiae filed.
Oct. 4, 1982	The motion of Arthur Andersen & Co. for leave to participate in oral argument as amici curiae is DENIED.
Nov. 9, 1982	ARGUED.